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### TAX POLICY AND THE PURSUIT OF JUSTICE

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Anyone may arrange his affairs so that his taxes shall be as low as possible; he is not bound to choose that pattern which best pays the treasury. There is not even a patriotic duty to increase one's taxes . . . nobody owes any public duty to pay more than the law demands.

—Judge Learned Hand

Taxes are the price we pay for a civilized society.

—Justice Oliver Wendell Holmes

### COURTS AND JUSTICE

In the aftermath of Hurricane Katrina, congressional Republicans offered a detailed list of cuts in the federal budget to offset the enormous cost of recovery and reconstruction. Among the featured items was a proposal to increase the audits of those claiming the Earned Income Tax Credit, a tax credit designed to provide financial assistance to working low-income individuals. Those claiming the credit in 2005 had a median income of less than \$12,000. By separating the truly poor from those who were merely “non-affluent,” the Republican proposal claimed an estimated savings of \$85 billion over ten years. At the same time, the Republican Party continued to urge the complete and total elimination of the Federal Estate Tax, which affects roughly one percent of all taxpayers, and which even the official estimate puts as a revenue loss of \$396 billion dollars over a similar ten-year period.

Public policy often favors one group over another. It is expected that the dominant or governing political coalition will offer tax policies that favor one group for a variety of reasons—from benefiting political supporters to notions of sound economic policy. The dominant or governing coalition

can be defined by party or ideology. Generally, if one party controls the elective branches of government, we can define that party and its goals as the dominant or governing coalition. Many times in American history the same party has controlled the presidency and both houses, or at least one house, of Congress. This assumes that each party is bound by certain core ideological assumptions—for example, the nature of federalism and the respective power of the state and federal government, or the extent and size of federal regulatory authority over markets, working conditions, and income.

If the policy is improperly applied or enforced, the disfavored group can always assert their rights in court. Audited low-income taxpayers claiming the Earned Income Tax Credit can challenge the assessments by filing a lawsuit against the Internal Revenue Service (IRS). The expectation is that, as Justice Harlan wrote in his dissent in *Plessy v. Ferguson*,<sup>1</sup> “all citizens are equal before the law. The humblest is the peer of the most powerful.”

One of those audited working poor seeking equality before the law is Joy Anders, a day-care-center worker from Phoenix, Arizona. In one particular year, Joy earned \$5,700, which she used to support herself and her sixteen-year-old son and claimed an Earned Income Tax Credit of \$1,500. However, because Joy lived with her mother, whose sole source of income was a pension paying less than \$7,200 per year and therefore unearned, the IRS rejected Joy’s claim to the Earned Income Tax Credit. The IRS claimed that although Joy’s mother did not file a tax return, Joy’s son was not a qualifying child because that child also lived with the grandmother and the grandmother’s income was unearned. The IRS immediately assessed an additional tax of \$1,500, the amount of the credit, plus interest, and also notified Joy that penalties would accrue if the balance were not paid within ten days. With the pro bono assistance of a local attorney, Joy filed a claim in Tax Court, and penalties and interest accrue as Joy tries to navigate through the arcane meanings of a “qualifying child.”

Despite assertions of fairness and equality, evidence suggests that Joy will have difficulty proving her claim. Taxpayers do not do very well challenging assessments and in particular challenged Earned Income Credits rarely survive court scrutiny. Perhaps this should not be surprising. The dominant political coalition sees many earned income claims as fraudulent and Robert Dahl argued many years ago that court rulings rarely conflict with the preferences of the majority political coalition. Modern research largely supports this assertion. Recent scholarship has found, for example, that the majority political coalition uses courts to accomplish goals that it cannot achieve through the legislative process (see, e.g., Whittington 2005). Despite this research, it is still the prevailing belief in this country that a court is the one branch of government that protects the minority against the power of the majority, and that courts exist to ensure “justice as fairness” (Fogel and Hudson 1981).

This book examines these competing claims and beliefs about the American legal system in the area of tax policy and tax enforcement. Taxes and tax policy are perhaps the dominant domestic public policy issue of the past twenty-five years, taking only a backseat to post 9/11 national security concerns, and there is a complex legal system with competing federal trial courts that taxpayers can access to fight tax assessments. As one respected policy analyst noted, throughout the 1980s there were more frequent and detailed changes to the tax code during this decade than in any other period in U.S. history (Steuerle 1991), and the pace of tax legislation has not diminished with succeeding decades. Both Presidents Clinton and George W. Bush's initial major domestic policy proposals dealt with taxes. Taxes and tax policy continued as a major focus of campaigns, policy debates, and legislation. The role of courts is critical in ensuring fairness in tax policy and acting as an institutional barrier against the power of government.

Taxpayers challenging tax assessments annually file over 30,000 cases. Few tax cases are appealed and even fewer involve low-income taxpayers. Most cases are disposed of at the trial level and there are competing courts that litigants of all income levels use; the two most important are the Federal District Court, the trial court of general jurisdiction within the federal courts system, and the U.S. Tax Court, a specialized trial court created under the Article I legislative power of Congress. These courts are the front line in the guerilla war between taxpayers and the IRS and these are the courts that low-income taxpayers like Joy Anders turn to for relief against the IRS and the power of the political majority. Do these courts protect the rights of the individual, particularly the low-income taxpayer, or do they enforce dominant policy preferences? Do they influence the IRS to change its audit behavior and focus less attention on the lowest income group of taxpayers? Is there a difference in these courts in their decisions and in their relative influence on the IRS?

This book attempts to answer these questions. I argue and demonstrate that courts differ little from the national policy makers in their approach to tax policy and tax enforcement and, in fact, the president and Congress can use the courts to support their tax policy goals. Because of this, it is unreasonable to expect low-income taxpayer to fare well in our court system. To argue this premise, I examine the tax litigation process from the initial decision of choosing the tax forum, through an analysis of the decision making process in these competing courts, to an examination of the respective influence and impact of these different tax forums.

The book shows that while fairness before the law might be a laudable goal, the appointment process ensures that tax policy and tax enforcement rulings by the courts reflect the dominant political beliefs. Given the longer tenure of the federal judiciary, it is quite possible that even if the national coalition changes in the next few election cycles, which in turn could lead

to changes in tax policy and tax enforcement, the judiciary will fall short of ensuring the new coalition's notions of fairness in the tax policy domain.

#### TAXES AND TAX POLICY

Taxes and the courts have always been intimately intertwined, and the statements that begin this book from two famous judges represent the dichotomy of the attitude that law, and, by extension, the judges who interpret and rule on the law, have to taxes. Judge Learned Hand, one of the most renowned of all appellate court judges, summarizes one attitude that the law, and the public, has toward our tax burden: no one likes to pay taxes and all taxpayers have the right to do whatever they legally can to minimize their tax burden. Yet, as Oliver Wendell Holmes notes, taxes are the price we pay for a civilized society. Minimization of one's tax burden means fewer resources for the government. Without income tax revenue, we would have no army, navy, highways, or airports. We would have no FBI or CIA, or even any disaster management agency. It is unrealistic to think that these potentially divergent judicial attitudes are meaningless when it comes to judicial rulings on taxes and tax policy or that judicial attitudes have not played an important role in the formation and development of tax policy almost since the inception of the income tax.

The first income tax laws were enacted in 1861 and 1862 to fund the Civil War.<sup>2</sup> These same acts created the IRS.<sup>3</sup> The Estate of Abraham Lincoln was even issued a tax refund for an overpayment. After the need for revenue to fund the Civil War diminished, these income tax laws expired. The growth of the progressive movement, the increase in the size of the national government, and the increase in U.S. involvement in international affairs all lay in the future and the current customs duties were sufficient to fund the operations of the federal government.

Our story of the interaction of courts, national politics, and taxation really begins in 1894, almost thirty years after the end of the Civil War. Responding to dissatisfaction with high tariff rates and the need to raise revenue, Congress relied on its powers granted by Section 8 of Article I of the U.S. Constitution and passed a federal income tax for the first time since acts passed to fund the Union's fight against the Confederacy. While almost all in our modern world accept the constitutionality of the income tax, the arguments for and against it echo much of the controversy one hears today about taxation and these arguments have the same ideological and partisan filters. Liberals and Democratic politicians supported the income tax while Republicans and conservatives opposed it. For those in favor of the income tax, it was seen as a crucial element of the progressive agenda, which sought, among other things, fairness and equity in the collection of revenue for the United States. Progressive advocates and Democratic

politicians attacked the tariffs as regressive and hurting the poor and lower classes by increasing the costs of goods. Thus, Democrats viewed the income tax as a progressive measure and a fairer way to raise revenue. Republicans, however, argued that the income tax amounted to a socialist redistribution of income. The income tax would sap initiative and punish the hard work which leads to the accumulation of capital.

Unlike many in his party, Democratic President Grover Cleveland personally opposed the imposition of the income tax on individuals (Witte 1985). However, because of the favorable and politically popular tariff relief provisions attached to the legislation, Cleveland reluctantly signed the income tax into law (Whittington 2005; Witte 1985). As part of the tax legislation, banks were required to pay a two percent tax on income in excess of \$4,000. One such bank that had to pay an income tax was the Farmers' Loan Bank located in Massachusetts. In a contrived case, Charles Pollock, a shareholder in the Farmers' Loan Bank, sued to enjoin the bank from paying the income tax. Eventually, the lawsuit, *Pollock v. Farmers' Loan & Trust Co.* (1895), reached the Supreme Court of the United States.

After two hearings, Chief Justice Fuller, writing for a scant 5–4 majority, struck down the income tax as an unconstitutional direct tax. Among other reasons, the Court focused on the part of the statute that included rents from real estate as income. Land is subject only to direct taxation, the opinion stated, and you cannot separate income from the land itself. Therefore, the Court held, this provision violated the apportionment provisions of the Constitution. One cannot apportion tax on land because such a tax must be in proportion to the population.

Of course these bare and very questionable legal reasons hid the underlying emotions of the case and views of the social desirability of the income tax. Despite Chief Justice Fuller's admonition in his majority opinion that "we are not concerned with the question whether an income tax be or be not desirable," Joseph Choate, the lead attorney for the plaintiff, attacked the law as "communistic" and "socialistic" (Hall, Finkelman, and Ely, Jr. 2005, p. 385). Certainly other justices on both sides saw the decision in ideological terms far outside of bare-bones legal reasoning, with some commenting on the emotions and lack of logic in the respective opinions of those with whom they disagreed.

Called the "most controversial case of its era" (Hall et al. 2005), one scholar (Whittington 2005) has recently argued that the *Pollock* case provides a strong example of how the dominant political coalition uses the courts to achieve political goals that it cannot reach through legislation. In this set of circumstances, because of the complications and unpopularity of high tariffs, President Cleveland and the legislators in Congress opposed to the income tax were forced into supporting compromise legislation that enacted an income tax since it was the only political avenue open that

would lead to a tariff reduction. Unhappy with the bundled income tax part of the legislation, President Cleveland and those legislators opposed to the income tax supported the effort to overturn the tax through the courts as an unconstitutional tax. Thus, an attempt at progressive taxation was stymied by the courts acting in concert with national political interests.

The decision met with great criticism and, even though the tariff provisions were upheld, dissatisfaction with tariffs as a primary source of revenue continued. Because of these circumstances, a coalition of newly elected liberal Republicans and progressive Democrats began to seek legislative reenactment of an income tax. Under the guidance of then President William Howard Taft, who was fearful of a constitutional crisis between Congress and the Supreme Court, Congress agreed to a compromise. Congress would propose a constitutional amendment specifically allowing an income tax without direct apportionment based on population and Congress would pass an excise tax on corporate profits but no tax on individual incomes. With the compromise, Congress overwhelmingly passed an amendment to the U.S. Constitution in 1909 permitting an income tax without apportionment with a near unanimous vote in the House and a unanimous vote in the Senate. State ratification was slow, with mostly southern states supporting it and many eastern states reluctant to vote for the amendment. Northern states were far more industrialized, and the economy of the southern states depended greatly on agriculture and farming. Northern states therefore feared that the income tax burden would fall unevenly on the taxpayers of their states and the southern states would pay much less.

Eventually, in 1913, the necessary thirty-sixth state ratified the Sixteenth Amendment, providing the constitutional basis for the right of Congress to authorize the collection of a federal income tax.<sup>4</sup> The Sixteenth Amendment overturned the 1895 *Pollock* decision, and this remains one of the few times when a constitutional amendment has overturned a constitutional ruling of the Supreme Court.<sup>5</sup> The ratification coincided with major Democratic victories in the 1912 election, including the election of President Woodrow Wilson, the first Democratic president since Grover Cleveland. This new more progressive Congress then enacted income tax legislation in the same year as ratification of the Sixteenth Amendment, upending President Taft's compromise position.

This first income tax was, by any modern standard, extremely modest and of limited reach. The top rate for all taxpayers was six percent for incomes over one-half of a million dollars (\$500,000), an enormous figure in 1894 America and the equivalent income in excess of \$11 million in today's dollars. Only about two percent of the labor force filed tax returns during the first two years of the new statute's existence (Friedman 2002). Even under a revised income tax law enacted in 1916, the first \$3,000 (\$4,000 for married couples) of income was exempt, an income equivalent today of

almost \$54,000 for single people and over \$71,000 for married couples. The upper rate increased to thirteen percent, but only on incomes in excess of \$2,000,000 per year; only the very few wealthiest would ever pay this rate, and most paid no tax at all.

Even so, this modest income tax led to significant opposition. The most affluent Americans and the business community were the most outspoken in their opposition to the income tax. The wealthy saw the fairly small tax as a stalking horse for far greater income redistribution. The fear was that there would be a call for increased income taxation of wealth and eventually, to paraphrase Joseph Choate, a progressive income tax would lead to socialism.

While socialism has never occurred, not all these fears regarding increased rates of taxation were misplaced. Just one year later, to finance World War I, the government dramatically increased income tax rates and also imposed an excess profits tax on business. The maximum rate increased to seventy-seven percent, and from almost no influence on federal revenue prior to 1916, individual and corporate tax income accounted for sixteen percent of federal revenue. Between 1917 and 1920, revenue from these income taxes constituted almost sixty percent of all federal revenues. The tariff, once the centerpiece of federal revenue, now saw its importance to the economy and public policy decline in dramatic fashion. The revenue and importance of the income tax dwarfed the money generated by, and the consequence of, tariff collection. With this shift in importance came both significant opposition and tax evasion (or the more preferable term of tax avoidance), along with of course the use of courts to settle taxpayer and government disputes.

With the end of World War I and a coming decade of Republican presidents and Republican majorities in Congress, both tax rates and the progressive nature of the income tax declined. Even Democrats led by outgoing President Wilson questioned the need for such high maximum rates and thus the effective top tax rate was reduced to twenty-four percent. Although a push was made by many wealthy businessmen to eliminate the income tax, Secretary of Treasury Andrew Mellon, no fan of disproportionate tax rates, convinced enough Republican officeholders that some degree of progressive taxation was socially responsible and beneficial for political purposes.

With the support of a Republican administration, the income tax was now a permanent fixture of American political and economic life. Between the turn of the century and 1925, total internal revenue collections from income tax grew from \$207 million to \$3.2 billion. By comparison, customs duties climbed only from \$185 million to \$464 million during the same period (Chommie 1970; Witte 1985). The Bureau of Internal Revenue grew along with its collections. The number of employees increased from 4,000 in 1913, a number that had remained almost constant for more than half a century, to close to 16,000 by 1920.

However, what the top and bottom rates should be, whether and to what extent the tax should apply to corporations as opposed to individuals, whether and when excess profits should be taxed, whether estates would be taxed, and what constitutes income, among other questions, would remain to be argued about and ruled on over the coming decades. In fact, just nine years after the passage of the Sixteenth Amendment and the subsequent constitutionally permissible income tax legislation, the first book to help taxpayers avoid excess taxation was published. It was entitled *Minimizing Taxes*, and written by Wall Street lawyer John Sears. Foreshadowing Judge Learned Hand, Sears wrote his book from the point of view of the taxpayer, offering advice on how to minimize taxes legally, which in Sears's view amounted to the patriotic goal of "exposing evils in the system."<sup>6</sup> To paraphrase Sherlock Holmes, the game was afoot.

In the decades that followed, tax policy continued to be a function of "revenue demands and ideology" (Witte 1985, p. 96). Even though the critical election of 1932 brought Franklin D. Roosevelt and solid Democratic majorities power, there was no immediate push for more progressive tax rates. Throughout the Depression, lower maximum income tax rates meant that relatively few individuals paid any income tax, although the 1930s did see the imposition of the Social Security tax, bitterly fought by business, but a regressive tax on individuals. The Supreme Court with a narrow majority<sup>7</sup> upheld the Social Security tax. Income tax revenues accounted for about forty percent of all federal revenue. Once again, war came. Just as World War I changed assumptions about the need for government revenue and the appropriate source for such revenue, World War II would also lead to a significant increase in the need for revenue and alter the nature of income taxation.

With this need for revenue and full employment led by massive government spending to both finance and support the war effort, tax rates increased and more individuals were subject to the income tax than ever before. A surtax was imposed on the income tax that started at a rate of thirteen percent on the first \$2,000 of income and went up to eighty-two percent on incomes over \$200,000. In addition, the federal government imposed a guaranteed collection mechanism that had the additional benefit of ensuring a steady stream of tax revenue throughout the year. Income tax withholding was introduced for the first time. More than one-third of Americans now paid some form of income tax and the tax was by far the dominant source of governmental income. By 1945, about 45 million American paid an income tax out of a total population of some 132 million people, and income taxes accounted for over seventy percent of all federal revenues.

In the immediate aftermath of the war, income and corporate taxes were roughly equal; however, during the succeeding decades, the individual income tax began to dominate corporate revenue, as more and more earners



became subject to the income tax. Although some attempts were made to reduce taxation following World War II with a brief Republican takeover in Congress, Truman's reelection and the revenue needed to fight the Korean War forestalled any significant change in tax rates and the importance of the income tax. President Eisenhower resisted tax reduction throughout his term of office and, with the passage of the Internal Revenue Code (IRC) of 1955, tax rates stabilized.

Another change during these years was the increase of individual income tax revenue compared to corporate tax revenue. From the 1920s through World War II, tax collections from corporations and individuals were equal. By 1955, however, individual income taxes provided \$31.6 billion of income tax revenue, while corporations provided \$18 billion. The disparity between corporate and individual taxes continues to this day (Witte 1985, p. 124).

The ensuing decades saw movement back and forth between cutting taxes as a stimulus to the economy and raising them to finance the Vietnam War and new government social and economic programs. Considerable government expansion led to both a much greater need for revenue and collection and tax practices that significantly increased federal revenue. By 1968, the IRS was collecting \$78 billion from individuals and \$30 billion from corporations. By the mid 1990s, individuals paid almost \$600 billion in income taxes and corporations more than \$150 billion and the top income tax rate at one point climbed to fifty percent.

Of course, expansion of government services and spending and the subsequent expansion of income tax rates and income tax collections led to increases in opposition to such government spending and tax collection rates. By 1980, due to inflation outpacing income gains, many American taxpayers were paying increasing tax rates without any corresponding real increase in income or buying power. A tax revolt was imminent and voters in both Massachusetts and California passed initiatives that capped property taxes. A similar movement was under way to reexamine and lower income tax rates.

A rejection of high-income rates became one of the cornerstones of the presidential campaign of the Republican candidate Ronald Reagan. With his election came Republican control of the Senate, and in his subsequent presidency Reagan proposed and Congress adopted a tax package that decreased top rates soon after he took office. This was not the end of his presidency's altering of tax rates. With bipartisan support, Congress enacted the 1986 Tax Reform Act, which, although revenue neutral, led to a large decline in progressive tax brackets, reducing over fifteen brackets to two.

However, once again income taxes and the controversy as to the proper method and rate of collection resulted in additional changes during the ensuing decade. Concern about large federal deficits led both the George

H. W. Bush and Bill Clinton administrations to once again increase tax rates and tax collections. For example, a third tax bracket was created and top rates climbed again to almost forty percent. George W. Bush ran, in part, in opposition to the imposition of more taxes and promised to reduce government spending and lower maximum tax rates. With his election, some of his initial legislation dealt with taxes. Thus, in the second Bush administration, maximum tax rates again declined and the Estate Tax was significantly reduced with a goal of eventual elimination.

#### COURTS, FAIRNESS, AND TAXES

Millions of tax returns are filed each year and individual income tax collection is by far the single most important source of all federal government revenue. With so much money collected from so many people, significant conflict between individuals and the U.S. taxing authority, the IRS, becomes inevitable. In a typical year, taxpayers file over 100 million individual tax returns. The individual taxpayer initially determines his or her tax liability by calculating income and deductions and then filing a tax return to the appropriate IRS office, along with the amount of tax payment due to the government.<sup>8</sup> The taxpayer is expected to comply with the tax laws and honestly report income, exemptions, and deductions. This is our system of self-assessment, one called “quasi voluntary” (Daily, 1992 p. 1/7; Freeland, Lind, and Stevens 1977, p. 971).

Increasing rates and growing complexity lead to more incentives for avoidance and evasion and a greater need for planning. Tax cheating, in the form of outright noncompliance, is a severe problem. Many sources, including scholars, the IRS, and journalists, estimated that, in the 1970s and 1980s, noncompliance resulted in an unreported taxable income shortfall between \$61 and \$80 billion per year (IRS 1979; Kurtz and Pechman 1982). By 1986, Roth, Scholz, and Witte (1989) note that the IRS estimated that individuals failed to report between \$70 and \$79 billion in income received, and that the figure might in fact be closer to \$100 billion. Philip Brand, the IRS’s chief compliance officer, verified the \$100 billion figure for the tax year 1994.<sup>9</sup> This amount is nearly twenty percent of all reported income.

When income is underreported, the IRS collects less tax. The lack of compliance represents a severe loss of revenue for the government. Because of these problems, the IRS will closely examine a certain number of returns in a procedure known as an audit. It is the most powerful policy tool the IRS possesses (Burnham 1989; Roth, Scholz, and Witte 1989; Scholz and Wood 1998; Steuerle 1986). In its simplest form, an audit is a detailed examination of a taxpayer’s income tax return.<sup>10</sup> The audit seeks to determine if the taxpayer is actually telling the truth in the claims made on the income tax

return. The IRS does not accuse the taxpayer of wrongdoing, but instead seeks justification and verification of the listed income and expenditures.

Taxpayers seek to avoid paying excess taxes and the IRS seeks to collect all taxes due and thus audits a selected number of returns both to determine individual tax liability and to try to ensure overall compliance. As one scholar of American law noted, "tax avoidance became a national pastime . . . the Internal Revenue Service and the taxpayers became locked in a kind of dance, a rumba of avoidance and counteravoidance" (Friedman 2002, p. 395). Because of this dance of conflict, the taxpayer and the IRS often fail to resolve the matter to the satisfaction of one or the other, usually the taxpayer. When this course and all appeals fail, the taxpayer can turn to the courts to settle the disputes and courts become a major player, not just in the individual dispute, but in the overall formation and enforcement of U.S. tax policy.

Perhaps we can call the courts the dance instructor or the referee of the rules of the dance. The Supreme Court has issued opinions on major tax cases involving more than 200 tax disputes since the beginning of the Warren Court (Epstein et al. 2003), more than any domestic policy domain. The greatest percentage of Supreme Court cases during the Warren Court years involved controversies over the IRC. During the Burger and Rehnquist Courts, IRC controversies accounted for the third and second highest percentage of cases (Epstein et al. 1992, pp. 553–54).<sup>11</sup> Tax cases also represent a very large part of the docket of the U.S. Court of Appeals. For example, during the years 1997 to 2004, the Circuit Courts of Appeals handled, on average, more than 220 new tax case appeals per year.

This heavy Supreme Court docket of tax cases is remarkable considering the assertion of one scholar that the Supreme Court is reluctant to take such cases because of the justices' lack of interest and the issue complexity (Perry 1991). Among major cases, the Supreme Court has determined what constitutes income,<sup>12</sup> acceptable business and personal deductions,<sup>13</sup> and taxable consequences of divorce.<sup>14</sup> All of these represent claims by the IRS following post audit assessments; they pitted one party against the IRS, and hence against the government of the United States. Although the taxed parties were concerned with their individual liability, the holdings of the Supreme Court have significantly shaped and determined tax law and tax policy.

However, despite these raw numbers and major cases, most matters are disposed of at the trial level, and, unlike other legal areas, the tax domain uses a system of competing courts. These courts allow litigants of all income levels to assert their claims against the IRS. The two most important of these tax trial courts are the U.S. Court, the trial court of general jurisdiction within the federal court system, and the U.S. Tax Court, a specialized trial court created under the Article I legislative power of Congress. These two

courts, along with the U.S. Court of Federal Claims, are the courts that decide the winners of the battles between the IRS and taxpayers and these are the courts that low-income taxpayers turn to for relief against the IRS and the power of the political majority. Given the particular prominence of taxes and tax policy over the past three decades, where tax litigants choose to sue, how these tax trial courts make decisions, and the impact of these decisions are critically important if one wants to understand the dynamics of not just tax policy, but public policy. Courts need litigants to bring a matter to them before they have a chance to rule on any particular matter and these lawsuits can change public policy by forcing the agency to expend time and resources fighting the litigation and then having to comply with the directives of these courts.

The balance between legal avoidance as advocated by Judge Learned Hand and illegal tax evasion, those seeking to avoid what Oliver Wendell Holmes called the “price we pay for a civilized society,” is the point when courts step in and rule either in favor of the taxpayer or in favor of the United States. Taxpayers have a right to pay as little as legally possible, but if the taxpayer does not pay what is truly owed, “the price we pay for a civilized society,” then all the other taxpayers bear this burden and the noncompliant taxpayer becomes the free rider enjoying the benefits, but not the burdens, that federal spending bestows.

Most cases that confront the trial courts present few difficult issues or problems. Often a small number of facts are in dispute and the cases involve few, if any, complex legal issues. However, many are not and the courts have to pick a winner and a loser with often devastating consequences to the taxpayer if the courts rule for the government. Often, however, regardless of how the courts rule, these decisions have other consequences. If courts consistently rule in favor of one type of one income level of taxpayer as opposed to another income level, or rule in favor of corporations as opposed to individuals, those decisions become part of the tax policy of the government and influence the ideals and perceptions of justice, fairness, and the notion that all citizens are equal before the courts. How courts decide these matters is the fulcrum on which we attempt to answer these questions. How they decide these cases has much to say about how and why we treat the taxpayer who uses the Earned Income Tax Credit and the taxpayer who employs the services of top accounting and law firms.

## CHAPTER OVERVIEW

Those looking for debate and analysis of the legal arguments over the constitutionality, interpretation, and meaning of tax law will be disappointed. This is neither a textbook on the fundamentals of income taxation, nor a demonstration on how to survive a tax audit, nor advice on how to prepare

and win a court challenge. How a court should interpret a tax law—and the tax implications of the various interpretations—are properly the subjects of income tax textbooks and the domain of tax professors, tax lawyers, and those who provide income tax advice and assistance. These are obviously important topics for analysis and investigation, but this book is about the politics of courts and taxes, and whether courts deviate from the majority or enforce dominant beliefs in their rulings.

After the introduction, the chapters proceed down the path of an audited taxpayer. The chapters use the audit experiences of Joy Anders, along with those of a large multinational corporation, a wealthy taxpayer who invested in a tax shelter, and a middle-class couple whose deductions were challenged as the counterpoints for the examinations and analyses to follow. Chapter two provides an overview of the choices these types of taxpayers have in challenging a post audit assessment by the IRS. This chapter examines the trial options available to taxpayers, which are first internal appeals and then appealing the audit assessment either in the Tax Court, the District Court, or the Court of Claims. While most of the chapter is descriptive, I do provide an examination of the choices as well as the costs and benefits of the particular trial forums. Ideally, the system should work to ensure that all taxpayers, regardless of wealth, have a fair and impartial forum to contest their assessments. However, arguably the least costly option might offer the smallest chance of success, calling into question the fairness of the options and ultimately the effect on compliance.

Chapters three, four, and five are the heart of the book and contain the analyses of this dance of courts, the IRS, and these taxpayers. Chapter three analyzes in detail the decisions of each of the potential litigants in choosing first whether to sue and then selecting a forum. To do this, I first describe theories of litigation, including rational actor theories and information asymmetries, and use these theories to examine both the decision to sue the IRS and, once that choice is made, analyze forum choice. Then I gather data from the years 1994 to 2000, which coincides with the Contract for America campaign through the Republican takeover of Congress in 1995 and finishes with the last year of President Clinton's term of office.

The chapter argues that tax policy has been politicized and ideologically divisive since the 1970s, with conservatives generally opposed to greater tax collection and enforcement. Therefore, as the political majority became more conservative over this time period, litigants were encouraged to challenge the assessments and thus one should find a corresponding increase in tax litigation in both the Tax Court and the District Courts. In addition, litigants should also be encouraged to choose the court that offers the greatest chance of a conservative judge because the more conservative the judge, the more likely the support for the taxpayer opposing the IRS. The effect on the specific taxpayers is then examined.

Chapter four describes the decision making of the two principal courts in which to challenge the IRS, the Tax Court and the U.S. District Courts. This chapter uses data from 1996 and 1997 to systematically examine the differences, if any, in the decision making of these courts. The chapter scrutinizes the specialized Tax Court and its expertise and sees if that leads to differences with the District Court in the use of ideological preferences in the outcomes of the tax cases, specifically focusing on judicial independence and congressional control. The chapter argues that the limited-tenure U.S. Tax Court uses its expertise, and lack of realistic structural or hierarchical constraints, to decide cases more in accordance with the Tax Court judges' personal policy preferences than do the judges of the U.S. District Courts. The chapter concludes with an assessment of each taxpayer's probability of success in each court.

Chapter five examines the aftermath of these decisions and the influence of courts on tax policy and tax enforcement. Specifically, beyond the immediate impact on the taxpayer, do these aggregate decisions change IRS behavior? Do they lead to greater auditing of Joy Anders and less examination of the large corporation? Do these decisions instead do the reverse and change IRS audits to benefit poorer taxpayers? Several studies have shown that national agency policy can change as the ideology or partisanship of the federal district or federal appellate court changes. Some agencies must contend with different federal courts with overlapping jurisdiction, and calculate responses to these different courts that have different judges, different ideologies, and different agendas while trying to carry out the preferences of the executive and legislative branches of government in a separation of powers system. This chapter applies these theories of influence and impact by examining the tax trial courts and the IRS. Using data from 1994 through 2000, and studying audit ratios of individual and corporate taxpayers, I find that the IRS pays attention to the preferences of the executive and legislative branches of government and the preferences of the Tax Court, but not the District Courts, in determining the ratio of audits of individuals and corporations, with the IRS responding to more conservative courts and more conservative executive and legislative preferences by shifting the audit rate toward auditing more individual taxpayers. The smaller variation in Tax Court ideology lessens the overall impact of the Tax Court.

Finally, chapter six offers a summation of the findings of this book and what these findings mean for tax policy, public policy, and the role of courts in a democracy. It is my hope that this book will accomplish two goals. First, it will underscore and demonstrate the importance of tax trial courts in setting and determining the nation's tax policy. Then I hope to add to the body of literature that shows that courts really represent and make rulings consistent with the preferences of the majority. They are not

out of control, but they do not really constitute the last best hope for the disenfranchised. In the end, perhaps both the independence and the non-democratic or antimajoritarian nature of federal courts are overestimated by friends and critics alike.