MORRISON | FOERSTER

STATE & LOCAL TAX
INSIGHTS

Mitchell A. Newmark & Pilar M. Sansone, Co-Editors *Summer 2005*

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Morrison & Foerster Hits Three Home Runs!

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The State and Local Tax team at Morrison & Foerster scored three big victories in recent months. First, after appearing before the San Francisco Assessment Appeals Board, the team secured a $100 million reduction in the assessed value of a sports team's stadium. Second, the team successfully argued before the Illinois Appellate Court that two publicly traded companies with separate boards of directors were not unitary. Third, the team successfully demonstrated to the Missouri Administrative Hearing Commission that the gain from an IRC Section 338(h)(10) transaction recognized by a Connecticut power company, with a facility in Missouri, constituted nonbusiness allocable income for Missouri tax purposes.

THE SAN FRANCISCO GIANTS' PROPERTY TAX VICTORY

Morrison & Foerster represented the San Francisco Giants baseball team in its property tax appeal before the San Francisco Assessment Appeal Board in a case that presented novel issues regarding how major league sports facilities should be valued and assessed. During a lengthy hearing this past spring, the Giants and the Assessor presented evidence on the fair market value of the team's possessory interest in SBC Park stadium. Following the hearing, the Board reduced the assessed value of the Giants' ball park by approximately $100 million for each of the years appealed, which will generate a refund of approximately $3.6 million. Although the Board an-

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nounced its decision in July, it has yet to issue its findings and determinations. We will provide a detailed analysis of the Board's findings in a later edition of this newsletter once those findings have been issued. Peter Kanter, Troy Van Dongen, and Jeff Terraciano of Morrison & Foerster's San Francisco Office litigated the case.

ILLINOIS FINDS THAT TWO PUBLICLY TRADED COMPANIES ARE NOT UNITARY

Morrison & Foerster also represented The Dow Chemical Company ("Dow") in its unitary appeal in Illinois. Dow sold its pharmaceutical subsidiary to Marion Laboratories, Inc. ("Marion") and received stock in Marion. Contrary to the evidence, the Illinois Department of Revenue asserted that Dow and Marion were unitary businesses based on facts that predated the years at issue. The Administrative Law Judge agreed with the State.

When Dow called on Morrison & Foerster to step in and handle the appeal before the Circuit Court, the Morrison & Foerster team demonstrated that during the years at issue, Dow and Marion, two publicly traded companies with separate boards, were not unitary, although there were many arm's-length agreements between the companies. The Circuit Court agreed with Morrison & Foerster for three out of four years, siding with the Department only on the one year during which that court found (in our view, incorrectly) that Dow's subsidiary was being transitioned to Marion. The Illinois Appellate Court agreed with the Circuit Court, and the State has not appealed. Paul Frankel, Craig Fields, Roberta Moseley Nero, and Mitchell Newmark of the New York Office handled the appeal.

MISSOURI FINDS SECTION 338(h)(10) GAIN IS NONBUSINESS INCOME

The Morrison & Foerster State and Local Tax team also represented ABB C-E Nuclear Power, Inc. ("ABB") after the Missouri Department of Revenue issued an assessment contending that gain recognized by ABB in an IRC Section 338(h)(10) transaction constituted business income for Missouri tax purposes. The team argued that although the stock sale of a subsidiary was deemed to be a sale of assets pursuant to ABB's IRC Section 338(h)(10) election, the deemed sale of assets was not made in the regular course of the subsidiary's trade or business – it was made in the course of liquidating that business as a result of the deemed liquidation component of the election. The Hearing Commission agreed with Morrison & Foerster that the gain on the sale was nonbusiness income. Paul Frankel and Craig Fields of the New York Office litigated the matter. ■

MoFo SALT Attorney News

Eric Coffill, Charles Moll, and Thomas Steele were included on the 2005 Northern California Super Lawyers list. The list includes the top five percent of Northern California lawyers, as ranked by their peers. ■

Remedies for Unapportioned Gross Receipts Taxes

By Charles J. Moll III & Pilar M. Sansone

When a tax is determined to be unconstitutional because it is not properly apportioned, is the proper remedy to impose the amount of tax that would have been allowed under a proper apportionment scheme, or is the entire amount of the proposed tax simply stricken? The California Court of Appeal recently addressed this issue involving an unapportioned tax on gross receipts and provided a needed wake-up call to the many California cities that still have defective taxes on their books: they will not be permitted to enforce an unapportioned tax against taxpayers, nor may they unreasonably delay in enacting apportionment guidelines—otherwise they will be barred from collecting even a fair and apportioned tax for past periods. *See City of Modesto v. National Med, Inc.*, 128 Cal. App. 4th 518 (2005). The court thus made it clear that cities must bear the burdens associated with remedying an unconstitutional tax; they may not shift that burden to the taxpayers who have been harmed.

BACKGROUND

National Med, Inc. ("NMI") was a health maintenance organization headquartered in Modesto, with operations throughout the State of California. During the period at issue in this case—January 1996 through June 2000—the City of Modesto ("City") imposed a business license tax measured by gross receipts on entities engaged in business within the city. Although the United States and California constitutions require that gross receipts taxes be apportioned to prevent taxing the taxpayer's business activities outside the particular jurisdiction, the City's ordinance did not contain a provision entitling taxpayers to apportion their gross receipts during the period at issue.

Like many other California cities, the City hired an outside contingency fee auditor to examine its taxpayers' returns. Provided with the incentive of receiving a percentage of all additional tax revenues it could extract from NMI, it was not surprising when the contingency fee auditor claimed that NMI was not entitled to certain deductions it had taken and thus owed the City additional taxes.

NMI sent the auditor a letter in early 2000 explaining why NMI was entitled to claim the deductions it had taken and informing the auditor that, in any event, the City's tax was unconstitutional because it lacked an apportionment provision and thus taxed receipts NMI earned outside the city. NMI again raised the constitutional defects of the tax in its hearing before the Finance Director in 2001 and in several letters to the City Council. Nonetheless, the City stubbornly maintained that its credit for taxes paid to other jurisdictions cured this deficiency, and sued NMI to collect these additional taxes.

Despite NMI's efforts to have the City address the infirmities of its tax, the City aggressively pursued its collection—by denying NMI a hearing before the City Council, alleging in court that NMI violated the California False Claims Act, and demanding a letter of credit that was seven times greater than the amount of tax, interest, and penalties the Finance Director had determined was due. Indeed, the City's litigation tactics were so outrageous that the trial court later determined that the City had violated NMI's due process rights and awarded NMI $270,000 in damages and attorneys' fees in a civil rights action.

THE TRIAL COURT'S DECISION

In 2002, NMI filed a motion for summary adjudication on the grounds that the California False Claims Act did not apply to the filing of municipal tax returns and the City's tax was unconstitutional. It was not until this motion was pending that the City finally acknowledged that its tax was

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Remedies

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unconstitutional and amended its tax code to add an "apportionment" provision. However, the new provision merely called for the establishment of apportionment guidelines and did not contain any specific instructions as to how such an apportionment should be performed. The trial court thus found that the new provision was "nothing more than a promise to adopt specific apportionment language at some unknown future date" and that it did not "provide this Court (or taxpayers) with any guidance as to how NMI's activities within the City should be measured, or whether that measurement will fairly represent NMI's activities within Modesto." On this basis, the trial court held that the new apportionment provision did "not solve the constitutional infirmities in the City's gross receipts tax" and that the tax could not be enforced against NMI.

THE COURT OF APPEAL'S DECISION

The City appealed the trial court's decision. The City conceded in its appeal that its prior ordinance was unconstitutional and that apportionment was required. Nevertheless, the City argued that the case should be remanded to the Finance Director to allow the City to calculate and impose upon NMI a properly apportioned tax using guidelines that the City had passed in 2003—one year after it had amended its tax code to provide for the enactment of an apportionment provision, and almost a full year after the trial court ruled that its gross receipts tax was unconstitutional. However, the 2003 guidelines contained several procedural defects, which NMI identified for the court in its opposition brief. Shortly thereafter, the City amended the guidelines yet again, and claimed that the Court of Appeal should consider its new 2004 guidelines when rendering its decision, even though NMI had already completed its briefing in the case.

The Court of Appeal denied the City's request and held instead that the tax could not be enforced against NMI. Significantly, the court held that the new apportionment provision and guidelines could not be applied retroactively because the City Council did not act promptly, and the period of retroactivity was too long. The court further held that it could not judicially reform the former tax code to apply the apportionment provision and guidelines to the period at issue because doing so would improperly encroach on the legislative function. The court also concluded that the retroactive application of the apportionment provision and guidelines would violate NMI's due process rights by placing an unfair burden on NMI to produce documentation from up to nine years ago (i.e., 1996-2000), which it previously had not been required to maintain. The court also concluded that the City's apportionment provision was a substantive amendment to its tax code, and that the amendment could not be applied to the period at issue because the City Council had specified that only procedural amendments to the code should be applied retroactively. The Court of Appeal's decision became final in June 2005.

FUTURE IMPLICATIONS

The Court of Appeal's decision is consistent with California and United States Supreme Court precedent holding that taxing authorities may not enforce unapportioned taxes, courts may not reform unconstitutional ordinances unless the intent of the enacting body is clearly articulated, and retroactively imposed taxes must be limited to a very short period of retroactivity and must comply with due process requirements. The Court of Appeal's decision serves as a valuable reminder of these basic principles and incorporates them into a thoughtful analysis of the issues presented by this case.

From a more practical perspective, the court's decision also makes it clear that cities will not be permitted to overtax local businesses, requiring them to litigate well-established constitutional issues, and then, once the tax is declared unconstitutional, be allowed to simply impose the tax that should have been charged in the first place. In other words, the Court of Appeal's decision provides cities with an incentive to comply with the Constitution from the outset, thus encouraging the protection of all taxpayers—even those without the resources or incentive to litigate the issue.

The Court of Appeal's decision also discourages the "legislate as you litigate" tactics employed by the City in this case. As discussed above, NMI informed the City that its tax was unconstitutional in 2000. Yet, rather than responding to NMI's legitimate concerns, the City waited until 2002 to amend its tax code, then enacted apportionment guidelines in 2003 and amended those guidelines 2004 – all in direct response to issues raised by NMI during the litigation.

In addition to denying NMI the right to brief issues arising under the 2004 guidelines, the City's approach effectively created a moving target as to which version of the tax code or guidelines the court should examine and base its decision upon. Had the Court of Appeal permitted this behavior, cities would have no incentive to resolve constitutional infirmities present in their tax code unless and until absolutely necessary, which would lead to unnecessary litigation regarding issues that could have been resolved earlier in the case. The court's decision to limit the period during which apportionment guidelines may be retroactively applied discourages the use of parallel litigation and legislation tactics, preserves judicial resources, and provides taxpayers with greater certainty. ■

Charles Moll and Pilar Sansone, as well as Litigation partner Arturo Gonzalez, litigated this case.

Hammers Disguised as Amnesties: States Take a Wrong Turn

By Paul H. Frankel & Amy F. Nogid

In their zeal for tax revenue, state legislatures have enacted tax amnesty programs with increasing frequency. As a result of the startling successes of many of the programs, which had been touted as "One Chance for a Second Chance,"[1] "first and only,"[2] or a "once-in-a-lifetime opportunity,"[3] additional opportunities often followed at their heels, dubbed by one state official as "a second once-in-a-lifetime opportunity."[4] The Director of the Missouri Department of Revenue, in response to the enactment of back-to-back amnesty programs in 2002 and 2003, stated that she hoped that the Missouri Legislature did not "go for a trifecta."[5]

Since the first state tax amnesty program was enacted by Arizona in 1982, through January 2005, 40 states plus the District of Columbia and certain localities have adopted at least one amnesty program.[6] Most of the states have enacted amnesty programs multiple times, including several which have enacted three or more general amnesties, which are available with respect to all or most of the significant taxes imposed by the taxing jurisdiction, within the last 23 years, i.e., Connecticut, Massachusetts, Missouri, New Jersey, and New York. Louisiana has the distinction of having had four general amnesties in the last 20 years.[7]

While some states have enacted general amnesties, others have restricted amnesties to only certain taxes or situations. Virtually all types of taxes have been covered – income, property, sales, withholding – to name just a few. Recently, several programs have targeted taxpayers that have participated in "abusive" tax shelters.[8] "Abusive," however, is in the eye of the beholder. States apparently have forgotten the time-honored precedent that avoidance transactions are acceptable and only transactions that evade taxation are prohibited.

The widespread use of amnesty programs by the states and their frequency are not surprising given their purported financial successes.[9] Although a few programs did not meet their revenue targets,[10] most brought in revenues far in excess of estimates. For example, South Carolina's 2002 tax amnesty program collected 12 times the amount of revenue it had expected;[11] New Jersey's broad-based 1996 program generated five times its estimate;[12] and California's 2004

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amnesty program for tax shelter participants yielded a startling $1.4 billion, which was dwarfed by the almost $3 billion brought in by the Franchise Tax Board during its most recent foray into the amnesty realm, albeit most of the revenue was not paid as part of the amnesty program, but to circumvent the amnesty program.[13]

Amnesty programs' target audiences vary. Although the programs often target non-filers with the goal of placing these taxpayers on the states' tax rolls, they have been enacted to target collection of accounts receivable (e.g., collect on outstanding warrants) or to encourage taxpayers with "tax shelters" to come clean.

The states' munificence has varied from generous – full waivers of interest and civil penalties, a promise to forgo any potential criminal action or penalties, and even limited look-back periods – to onerous – threatening the imposition of newly enacted penalties on those who chose not to take advantage of the "voluntary" program. With alarming frequency, states have opted for the latter programs. Many of the elements of these programs are harsh and ripe for constitutional challenge.

BRIEF HISTORY OF AMNESTY PROGRAMS

"Amnesty" is defined (from the Greek *amnestia*, oblivion) as "an act of justice by which the supreme power in a state restores those who may have been guilty of any offence against it to the position of innocent persons. It includes more than pardon, inasmuch as it obliterates all legal remembrance of the offence."[14] Amnesty does not release the grantee from guilt but from the penalty that, but for the grant of amnesty, would be imposed by law for such guilt.[15]

In ancient Egypt, pharaohs were known to grant pardons for unpaid taxes during periods of hardship, in a practice known as "philanthropa" (from which the word "philanthropy" is derived).[16] During the reign of Ptolemy V, around 200 B.C., a "Proclamation of Peace" was inscribed which included tax amnesty provisions. Tax debts were forgiven, and tax debtors were freed from prison. A copy of this Proclamation of Peace was found by one of Napoleon's officers inscribed on black basalt – the famous Rosetta Stone.[17] As a result of oppressive taxation, it was believed that huge amounts of unpaid taxes had accumulated, resulting in massive confiscation of property and incarceration of many able-bodied tax debtors. Amnesty allowed the confiscated land to be returned to productive use by the formerly imprisoned tax scofflaws. As one scholar noted, "the grants of tax immunity set down in the Rosetta Stone paint a pitiful picture of Egypt and indicate that her rulers were driven to take desperate measures to end the social and economic chaos their excessive tax systems had created."[18] Apparently, the tax amnesty was deemed successful; three additional tax amnesties were ordered during the following century "as a regular medicine to check civil disorder."[19]

Tax amnesties have been used in many countries in both the developed and the developing world. In addition to countries in the Organisation for Economic Co-operation and Development (OECD) and most of the states in the United States, amnesties have been employed in Austria, Australia, Belgium, Finland, France, Greece, Ireland, Italy, Portugal, and Switzerland. Developing countries, where they have been employed often repeatedly, include Argentina, Bolivia, Chile, Colombia, Ecuador, India, Pakistan, Panama, Peru, Mexico, and the Philippines.[20] It has been argued that weak governments enact tax amnesties.[21]

Although the Internal Revenue Service ("IRS") had an administrative voluntary disclosure policy which offered taxpayers amnesty from criminal penalties (but not interest or civil penalties), that policy was officially discontinued in 1952, and the Federal government has never instituted a formal general amnesty program, although enactment of an amnesty program has been considered many times.[22] Notably, preceding the passage of the Federal Tax Reform Act of 1986, 13 different amnesty bills had been proposed.[23]

THE WISDOM OF TAX AMNESTIES: THE CONTINUING DEBATE

The wisdom of providing tax amnesties has been the subject of much debate. Some are of the opinion that tax amnesties, by their very nature, are the antithesis of the fundamental notion that punishment should follow crime.[24] As one commentator summed up: "A tax amnesty, by excusing civil and criminal penalties for avoidance of tax obligations, effectively severs the relationship between crime and punishment and compromises the fairness of the tax system."[25]

As a rule, tax officials do not favor tax amnesties since they benefit the non-compliant rather than the honest taxpayer. One small study confirmed the perception of many tax officials, finding that most individuals did not believe the government's statements that the program was a one-shot deal, and thought it was unfair to those who filed and paid their taxes timely.[26] Another study concluded: "Amnesty expectations reduce the positive effects of amnesty. When the state does not keep its promise, tax compliance decreases. Such a result has a strong policy implication. If a state had the intention to increase the long-term effects of a tax amnesty, its commitment should be reliable, and only one amnesty should be conducted per generation."[27] Legislators, however, focus upon the short-term infusion of cash and are usually not concerned with

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Upcoming Conferences

Following is a list of major conferences through December 31, 2005, in which Morrison & Foerster attorneys will be participating.

AUGUST 24, 2005
Philadelphia Chapter of TEI
Philadelphia, PA
Paul Frankel

AUGUST 29, 2005
FIST Conference
Houston, TX
Paul Frankel

SEPTEMBER 19, 2005
NESTOA Annual Meeting
New York, NY
Paul Frankel

OCTOBER 20, 2005
Chicago Tax Club
Chicago, IL
Paul Frankel

OCTOBER 20, 2005
Kentucky Chapter of TEI
Louisville, KY
Craig Fields

OCTOBER 20-21, 2005
Paul J. Hartman Salt Forum
Nashville, TN
Holly Hyans (20th)
Paul Frankel (21st)

OCTOBER 24, 2005
TEI Annual Conference
San Diego, CA
Paul Frankel

OCTOBER 27, 2005
New York University's Institute on Federal Taxation
New York, NY
Craig Fields

OCTOBER 28, 2005
COST Audit Session
Charlotte, NC
Paul Frankel

OCTOBER 28-30, 2005
The California Tax Policy Conference/State Bar Tax Section Annual Conference
San Diego, CA
Charles Moll
Carley Roberts

NOVEMBER 17, 2005
NYU's 64th Institute on Federal Taxation
San Francisco (Fairmont Hotel)
Tom Steele

NOVEMBER 17, 2005
TEI Connecticut State Tax Day
Hartford, CT
Paul Frankel

NOVEMBER 18, 2005
TEI New Jersey State Tax Day
Morristown, NJ
Paul Frankel

NOVEMBER 30, 2005
New Jersey CPA State Tax Day
Holmdel, NJ
Paul Frankel

DECEMBER 1-2, 2005
New York University's Institute on State and Local Taxation
New York, NY
Paul Frankel
Holly Hyans
Craig Fields
Eric Coffill

DECEMBER 5, 2005
TEI Annual Symposium
New York, NY
Paul Frankel

In 1984, the United States Treasury Department rejected the enactment of any type of amnesty program, stating: "To include tax, civil penalties, and interest in an amnesty would further undermine taxpayer morale by sending a clear signal to the American public concerning non-compliance and tax fraud: 'Don't bother to pay now.'"

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the potential long-term detrimental effects of an amnesty program.

In 1984, the United States Treasury Department rejected the enactment of any type of amnesty program, stating: "To include tax, civil penalties, and interest in an amnesty would further undermine taxpayer morale by sending a clear signal to the American public concerning non-compliance and tax fraud: 'Don't bother to pay now. We may forget you owe anything. Even if you have to pay tax, we won't charge interest.'"[28] The Treasury Department's 1984 report also noted that amnesties "reinforce the growing impression that the tax system is unfair and encourage taxpayer noncompliance."[29]

In 1990, an IRS commissioner concluded that a Federal tax amnesty would be "ill-advised and counter-productive."[30] From an economic perspective, the Joint Committee on Taxation's 1998 report on tax amnesty noted that economists had observed that "the granting of amnesty will forever change taxpayers' perceptions of the 'rules of the game' between the taxing authority and the taxpayer. Once an amnesty is granted, taxpayers may perceive that the likelihood of future amnesties has increased, and thus an incentive may be created to evade current taxes in anticipation of the future amnesty."[31]

Amnesties also upset tax systems' horizontal equity, i.e., treating those in similar economic circumstances equally, by treating those similarly situated differently. Further, with respect to amnesties that focus on collection and not on non-filers, the revenue is arguably merely accelerated; no new revenue source is tapped. One commentator called the states' amnesty successes "illusory," citing the results of California's 1985 amnesty program, in which the Franchise Tax Board had concluded that it would have collected 78% of the revenues even without the amnesty program, and an Illinois program would have collected 75% irrespective of its 1984 program.[32]

RECENT HEAVY-HANDED AMNESTY PROGRAMS

To assuage their unhappiness with such programs, tax departments urge legislatures to enact punitive provisions, which are appended to the amnesty programs. Tax officials lamented at one conference that the tax department did not have "a new stick," having enacted a 20% collection fee as part of the state's last amnesty program.[33] Use of the "stick," that is, implementation of excessive enforcement provisions, however, can "undermine compliance if such enforcement leads to an unnecessarily adversarial relationship between the taxpayer and government, leading taxpayers to 'get back' at the government by evading taxes."[34] Significantly, moreover, there is no consensus that an amnesty that has increased post-amnesty enforcement provisions reaps better results.[35]

While increased *enforcement* after an amnesty program might aid in the program's ultimate success (although there is evidence to the contrary), threatening to impose onerous penalties against taxpayers who have good-faith bases to challenge impositions is contrary to the fundamental goal of amnesty, is oppressive and unfair, and more importantly is violative of due process rights.

Illinois

The first of the states to change the fundamental nature of amnesty programs was Illinois. Its Tax Delinquency Amnesty Act of 2003 covered tax periods ending after June 30, 1983 and prior to July 1, 2002. It ran from October 1, 2003 through November 17, 2003, and covered all taxes administered by the Department of Revenue with the exception of the Motor Fuel Tax.[36] While certain of the provisions were generous – all penalties and interest would be abated – the punitive nature of the amnesty program was just as "generous" – taxpayers that failed to take advantage of the program would have interest and penalties assessed at 200%.[37] As the chief of staff of the Illinois Department of Revenue was quoted as saying with respect to the imposition of the 200% penalty and doubling of interest provisions: "It's a big stick. We wanted a big stick."[38]

Taxpayers paying under amnesty were required to relinquish their refund rights. A limited exception was provided for changes to taxpayers' income due to final determinations by the IRS or Federal courts.[39] The program introduces a prophetic element into tax administration, providing that "[f]ailure to pay all taxes due to the State for a taxable period shall invalidate any amnesty granted under this Act."[40] The regulations state that "a taxpayer must pay the *entire* liability for a tax type and tax period, *irrespective of whether that liability is known to the Department or the taxpayer, or whether the Department has assessed it*."[41] While using a big stick against tax scofflaws may arguably have some merit (but not necessarily in the context of an amnesty program), it is egregious to use a big stick against unwitting and unknowing taxpayers.

> [T]hreatening to impose onerous penalties against taxpayers who have good-faith bases to challenge impositions is contrary to the fundamental goal of amnesty, is oppressive and unfair, and more importantly is violative of due process rights.

Although the onerous penalty and interest provisions are troubling in and of themselves, particularly the assertion of the double interest and penalties against the unsuspecting, it is the "Catch-22" situation, i.e., either opt for amnesty and relinquish the right to pursue legitimate challenges to assessments or pass on amnesty and be subjected to the amnesty penalties if the challenge is unsuccessful, that is offensive to and violative of fundamental due process rights.

One example in the Department of Revenue's regulations provides that the amnesty penalties would apply to a taxpayer with questionable nexus "if a court were to determine" that nexus exists.[42] As state and local tax professionals are aware, nexus is a highly contested issue throughout the country with varying results. Fundamental notions of fairness require that taxpayers not be penalized for having exercised their due process rights.

While taxpayers that had civil cases pending in state courts were not eligible for amnesty, taxpayers who were contesting liabilities asserted before the Department of Revenue's Office of Administrative Hearings were deemed eligible for the program.[43] If these latter taxpayers wanted to avoid the potential imposition of amnesty penalties, they had to either "stipulate to judgment in favor of the Department"[44] or dismiss their administrative protests, pay under the Protest Monies Act, and commence civil litigation.

Taxpayers that had received notices of proposed deficiencies and had requested review by the Informal Conference Board ("ICB") were told by Department of Revenue officials that they had to withdraw their requests for ICB review, file amended returns reflecting the proposed assessment, pay under the Protest Monies Act, and proceed to court if they wanted to avoid double interest and penalties. Taxpayers that

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The FTB received almost $3 billion in payments from corporations, but it is estimated that the lion's share of such payments was from corporations electing to avoid amnesty.

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did so were met with motions to dismiss on the ground that such actions were not "ripe," since the taxpayers had not yet been issued notices of deficiency (just notices of proposed deficiency), and the allegation that, by filing the amended returns, they were "conceding" the asserted liabilities and the claim that the monies paid into the Protest Monies Act fund should be released to the Department of Revenue.[45]

The U.S. Supreme Court has long held that due process requires states to offer taxpayers procedural safeguards against "unlawful exactions."[46] A state may discharge this constitutional obligation in one of three ways by offering: (1) a predeprivation remedy, where a taxpayer can challenge a tax prior to payment; (2) a postdeprivation remedy, where a taxpayer can pay the disputed tax and sue for a refund; or (3) some combination of the two.[47] Under Illinois amnesty provisions, taxpayers have been divested of meaningful predeprivation and postdeprivation remedies.

A state's authority in devising and administering remedial schemes is not without limitations.[48] A fundamental limitation is that a state may not "reconfigure its scheme, unfairly, in mid-course—to 'bait and switch.'"[49] By requiring taxpayers to either accept the Department of Revenue's tax assertions or elect amnesty and forgo their opportunity to pursue their claims, bait and switch is precisely what the Illinois amnesty program did.

In *Reich*, the Court held that, under the Due Process Clause, a state may not offer "what plainly appears to be a 'clear and certain' postdeprivation remedy and then declare, only after the disputed taxes have been paid, that no such remedy exists."[50] The Court further explained that a state cannot deny a taxpayer relief on the ground that the state offered a predeprivation remedy when "no reasonable taxpayer" would believe that, in view of the apparent applicability of a postdeprivation alternative, the predeprivation remedy was the exclusive safeguard against illegal taxes.[51] As in *Reich*, Illinois reconfigured a long-standing remedial scheme.

Illinois' recent amnesty program left much to be desired – fairness and constitutionality – and set the stage for other offensive "amnesty" programs.

California

California recently ended two "amnesty" programs, one for corporate and personal income taxes administered by the Franchise Tax Board ("FTB") and another for sales and use taxes administered by the Board of Equalization ("BOE").[52] These two programs, which ran from February 1, 2005 through March 31, 2005,[53] followed in Illinois' footsteps, adopting many of the same punitive provisions. California's programs, however, were not as generous as Illinois' program inasmuch as only penalties for nonreporting or underreporting were forgiven.

Both of California's amnesty programs were applicable to years beginning before January 1, 2003 and were available to taxpayers that had not been under criminal investigation, and whose liabilities were not the subject of pending court litigation and could not have qualified for amnesty under the State's successful tax shelter "Voluntary" Compliance Initiative or the IRS's Offshore "Voluntary" Compliance Initiative.[54] While taxpayers were permitted to file refund claims under the sales/use tax amnesty program, corporate and personal income taxpayers could not file refund claims for amounts paid under amnesty.[55]

Like the Illinois program, California's amnesty programs adopted a prophetic element. Penalties would apply to liabilities that taxpayers had no knowledge of at the time of the amnesty program.

The existence of the post-amnesty penalties and the requirement that taxpayers forgo their disputes and rights to refunds resulted in taxpayers opting to pay within the amnesty period but outside the amnesty program. This permitted taxpayers with challenges to preserve their right to dispute paid amounts without subjecting themselves to the hefty penalty should they not prevail. The FTB received almost $3 billion in payments from corporations, but it is estimated that the lion's share of such payments was from corporations electing to avoid amnesty.

North Carolina

Taking a page from Illinois and California, North Carolina adopted a "Voluntary" Compliance Program, which was akin to the "tax shelter" reporting programs enacted by Illinois, California, Arizona, Connecticut, and New York, but had some of the offensive elements of the Illinois and California amnesty programs. The program, which was announced on December 28, 2004, was "in response to the North Carolina Court of Appeals' unanimous decision in *A&F Trademark, Inc. v. Tolson,*" a decision that was not (and is not, as of August 2005) final.[56] (A petition for certiorari has been filed in the United States Supreme Court). Entities participating in the program were required to pay all taxes and interest, without penalties, and were required to relinquish their refund rights.

In addition to the short time-frame provided to entities to consider the program, the Department of Revenue's decision to offer the program during the pendency of *A&F Trademark* was particularly troubling. The issue in that case, *i.e.*, whether income and franchise tax nexus exists without physical presence is, as mentioned above, probably the most contentious issue in state and local taxes today. It is an issue which will ultimately be resolved by Congress or the U.S. Supreme Court.

Given that penalties could total 60% of the tax due, entities were effectively bullied into relinquishing their due process rights. It is therefore not surprising that the "voluntary" program raised $255.6 million.[57]

AMNESTY PROGRAMS SHOULD GET BACK ON TRACK

While amnesty programs may not be in the states' best interests over the long haul, having decided to go the amnesty route, the states should get back on track. The new amnesty programs leave taxpayers scrambling to avoid their tentacles. States are divesting taxpayers (and purported taxpayers) of their right to challenge assessments without prepayment, by raising the interest and penalty stakes to newfound heights. This is contrary to the fundamental notion of amnesty and only serves to heighten controversies between states and taxpayers. It is anathema to fundamental rights of due process. You should not be penalized because you assert your legal rights. Losing your due process rights under the guise of an amnesty program makes the loss all the more offensive. ■

The new amnesty programs leave taxpayers scrambling to avoid their tentacles. States are divesting taxpayers (and purported taxpayers) of their right to challenge assessments without prepayment, by raising the interest and penalty stakes to newfound heights.

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[1] Robert D. Plattner, *Three-Month Tax Amnesty Begins*, 11 State Tax Notes 1282 (Nov. 4, 1996).

[2] Gary N. Ghioto, *State's "First and Only"*

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Amnesty a Winner, Officials Say, 14 State Tax Notes 1150 (Apr. 13, 1998).

[3] Karen Setze, *Officials Share Success Stories of Amnesty, Federal Offsets*, 29 State Tax Notes 180 (July 21, 2003).

[4] *Id.*

[5] Karen Setze, *Amnesties, Budgets Dominate Talk at Midwest Administrators' Meeting*, 29 State Tax Notes 619 (Sept. 1, 2003).

[6] http://www.taxadmin.org/fta/rate/amnesty1.html (as last updated by the FTA January 2005). In addition to the states, many localities have also taken advantage of amnesty programs, some multiple times.

[7] *Id.*

[8] *E.g.*, Illinois' Tax Shelter Voluntary Compliance Program, Pub. Act 093-0840 (2004).

[9] The actual success of many amnesty programs is difficult to gauge. Budgeting and estimation is often nothing more than a shot in the dark, and revenue departments may purposefully aim low so as not to encourage increased use of such programs and to ensure that, if a program is enacted, it will appear that they ran a highly successful program.

[10] *E.g.*, John S. Bartlett, *Nevada: Almost $2.5 Million Remitted During Use Tax Amnesty Period*, 5 State Tax Notes 1539 (Dec. 27, 1993); Rhode Island: Russell Garland, *Amnesty Falls Short of Goal but Raises Nearly $7.9 Million*, 11 State Tax Notes 1068 (Oct. 14, 1996); Wisconsin: Todd A. Berry, *Tax Amnesty to Fall Short of Predictions*, 15 State Tax Notes 615 (Sept. 7, 1998).

[11] Karen Setze, *Officials Share Success Stories of Amnesty, Federal Offsets*, 29 State Tax Notes 180 (July 21, 2003).

[12] Amy Hamilton, *Dole's Tax Amnesty: An Inspiration from the States*, 11 State Tax Notes 745 (Sept. 9, 1996).

[13] Lenny Goldberg, *California Amnesty Brings in Billions of Contested Revenue*, 2005 State Tax Today 67-7 (Apr. 8, 2005).

[14] http://en.wikipedia.org/wiki/Amnesty.

[15] *See generally* Leo P. Martinez, *Federal Tax Amnesty: Crime and Punishment Revisited*, 10 Va. Tax Rev. 535, 539-42 (1990-91).

[16] Charles Adams, *For Good and Evil: The Impact of Taxes on the Course of Civilization* 8 (1993).

[17] *Id.* at 19.

[18] *Id.* at 22.

[19] *Id.* at 23.

[20] http://www1.worldbank.org/publicsector/tax/amnesties.html.

[21] Elliot Uchitelle, *The Effectiveness of Tax Amnesty Programs in Selected Countries*, 14 Fed. Reserve Bank of N.Y. Quarterly Review 48 (Fall 1989).

[22] Joint Committee on Taxation, 105th Cong. 2d Sess., Tax Amnesty (JCS-2-98) (Jan. 30, 1998).

[23] Amy Hamilton, *Dole's Tax Amnesty: An Inspiration from the States*, 11 State Tax Notes 745 (Sept. 9, 1996).

[24] Leo P. Martinez, *Federal Tax Amnesty: Crime and Punishment Revisited*, 10 Va. Tax Rev. 535, 536 (1990-91).

[25] *Id.* at 565-66.

[26] George Violette, *An Analysis and Comparison of Maine's Tax Amnesty*, 2 State Tax Notes 403 (Mar. 23, 1992).

[27] Benno Torgler & Christoph A. Schaltegger, *Tax Amnesty and Political Participation* (2003); *see also* James Alm, *Tax Policy Analysis: The Introduction of a Russian Tax Amnesty*, Working Paper 98-6, Georgia State University Int'l Studies Program (Oct. 1998).

[28] Joint Committee on Taxation, 105th Cong., 2d Sess., Tax Amnesty (JCS-2-98) (Jan. 30, 1998).

[29] *Id.*

[30] *Id.*

[31] *Id.*

[32] Leo P. Martinez, *Federal Tax Amnesty: Crime and Punishment Revisited*, 10 Va. Tax Rev. 535, 558 (1990-91).

[33] Karen Setze, *Officials Share Success Stories of Amnesty, Federal Offsets*, 29 State Tax Notes 180 (July 21, 2003).

[34] Joint Committee on Taxation, 105th Cong., 2d Sess.,Tax Amnesty (JCS-2-98) (Jan. 30, 1998).

[35] Benno Torgler & Christoph A. Schaltegger, *Tax Amnesty and Political Participation* (2003).

[36] Pub. Act 93-26 (S.B. 969), Laws 2003, effective June 20, 2003.

[37] 35 ILCS 735/3-2(f) (interest); 35 ILCS 735/3-3(i) (failure to file or pay); 35 ILCS 735/3-4(d) (failure to file correct information returns); 35 ILCS 735/3-5(d) (negligence); 35 ILCS 735/3-6(c) (fraud); 35 ILCS 735/3-7.5(b) (dishonored check penalty).

[38] Karen Setze, *Amnesties, Budgets Dominate Talk at Midwest Administrators' Meeting*, 29 State Tax Notes 619 (Sept. 1, 2003).

[39] 86 Ill. Admin. Code § 521.105(l).

[40] Pub. Act 93-26 (S.B. 969), Laws 2003, effective June 20, 2003.

[41] 86 Ill. Admin. Code § 521.105(j) (emphasis added).

[42] 86 Ill. Admin. Code § 521.105(k)(5).

[43] 86 Ill. Admin. Code § 521.105(e) & (f).

[44] 86 Ill. Admin. Code § 521.105(f).

[45] The courts did not reach a consensus on the motions to dismiss; one Circuit Court judge denied a motion to dismiss, and another granted the motions to dismiss but ordered the monies refunded to the taxpayers. Eventually, the Department of Revenue issued notices of deficiency and stipulated to withdraw its motions to dismiss.

[46] *See, e.g., McKesson Corp. v. Division of Alcoholic Beverages & Tobacco*, 496 U.S. 18, 36 (1990); *Atchison, T. & S.F. Ry. v. O'Connor*, 223 U.S. 280, 285-86 (1912).

[47] *See Reich v. Collins*, 513 U.S. 106, 110-11 (1994); *McKesson*, 496 U.S. at 37.

[48] *James B. Beam Distilling Co. v. Georgia*, 501 U.S. 529, 535 (1991).

[49] *Reich*, 513 U.S. at 111.

[50] *Id.* at 108.

[51] *Id.* at 111.

[52] Stats. 2004 ch. 226, signed into law on August 16, 2004, and codified at Cal. Rev. & Tax. Code §§ 7070 *et seq.* and 19730 *et seq.*

[53] Cal. Rev. & Tax. Code §§ 7071 & 19731.

[54] Cal. Rev. & Tax. Code §§ 7072(b) & 19732(b).

[55] Cal. Rev. & Tax. Code §§ 7072(b) & 19732(e).

[56] This "one-time opportunity" was not authorized by North Carolina's Legislature. Letters were sent to entities that had received assessments with respect to transactions that the Department of Revenue considered to be "tax strategies where income that otherwise would be taxable in North Carolina is shifted out-of-state or other tax shelter activities that minimize or eliminate North Carolina taxable income." Even though many of the letters were not received until the first week of January, entities that had received assessments were required to pay such assessments on or before January 31, 2005, affording the assessment recipients precious little time to evaluate their options and seek necessary corporate authorizations. Entities that had not received assessments were given until February 28, 2005 to elect to participate in the program and until April 15, 2005 to make payment. *See* http://www.dor.state.nc.us/compliance/faq.html; http://www.dor.state.nc.us/press/jul04/voluntary_compliance.html.

[57] Kay Miller Hobart, *North Carolina DOR Reports $250 Million From Shelter Compliance Program*, 36 State Tax Notes 390 (May 9, 2005).

Ballard: The State Tax Implications Are Clear

By Paul H. Frankel & Amy F. Nogid

It has been said that "rules of procedure exist for the sake of substantive law and to implement substantive rights, not as an end in and of themselves. "Procedure should always be indeed the 'handmaid of justice.'"[1] In *Ballard*, the United States Supreme Court reminded the United States Tax Court – and, hopefully, all administrative and judicial forums that hear tax matters – that a fair, transparent procedure is critical to sound tax administration and determination of substantive rights.[2] The state tax implications are clear – secret reversals of internal administrative law judge decisions are improper and should cease. Better yet, systems that utilize internal hearing officers should be replaced with independent tax dispute resolution systems.

THE DECISION

Justice Ginsburg authored the Court's majority opinion, joined by six other justices. The Court held that the Tax Court's rules do not authorize the Tax Court's concealment of the report issued by a Special Trial Judge ("STJ") and the collaborative process that results in the issuance of a single decision of the Tax Court Judge which, invariably states that it "agrees with and adopts" the opinion of the STJ. The Court found that "[i]n comparison to the nearly universal practice of transparency in forums in which one official conducts the trial (and thus sees and hears the witnesses), and another official subsequently renders the final decision, the Tax Court's practice is anomalous."[3]

BACKGROUND

Ballard involved the assertion of fraud by the IRS against three individuals – Claude Ballard, Robert Lisle, and Burton Kanter – in connection with a purported kick-back scheme allegedley orchestrated by Kanter, a tax attorney and law school professor, with Ballard and Lisle, who had a long-standing relationship with Prudential Life Insurance Company of America to "sell influence" with regard to its real estate department.[4]

After a lengthy trial where 55 witnesses were called and over 6,000 pages of transcript were taken over a five-week period, the STJ assigned to hear the case had allegedly issued a report concluding that fraud had not been established by the IRS.[5] However, that report was never issued. Instead, the Tax Court judge assigned to render the decision concluded that fraud had been established, yet stated that "the Tax Court Judge agrees with and adopts the opinion of the Special Trial Judge."[6]

Although the STJ expressed his doubts about the IRS's establishment of fraud from the bench,[7] had it not been for conversations that counsel for one of the taxpayers had with two Tax Court judges who "were so offended by the unorthodox 'fact-finding' process used in this case that they revealed this off-the-record reversal to a lawyer who was, in turn, willing to make a record that neither the Tax Court nor the IRS has challenged,"[8] the taxpayers might not have known about the apparent about-face. Counsel for Kanter and Investment Research Associates filed a declaration in the Tax Court stating, *inter alia*, that he had been told that "substantial sections of the opinion were not written by [the STJ], and that those sections containing findings related to the credibility of witnesses and findings related to fraud were wholly contrary to the findings made by [the STJ] in his report. The changes to [the STJ's] findings relating to credibility and fraud were made by [the Tax Court judge]."[9] The declarant also stated that he was told by a Tax Court judge that "the changed sections of the report were

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written in such a way so that wherever there was the 'slightest issue of doubt, it went against' the Petitioners."[10] The taxpayers moved to gain access to the STJ's "reports, draft opinions or similar documents, prepared and delivered to the [Tax] Court pursuant to Rule 183(b)."[11] That motion was denied. A second motion was then filed by the taxpayers requesting that the STJ's report be placed under seal and be included in the record on appeal.[12] That motion was also denied. Another motion was then filed asking that the Tax Court reconsider its earlier denial of access to the report or requesting that another trial be held. That motion was denied as well, with a statement that the Tax Court decision adopted "the findings of fact and opinion" of the STJ.[13]

As a result of the rule which requires that appeals from Tax Court decisions be taken to the circuit court in which the taxpayer resides,[14] Ballard's appeal was heard by the Eleventh Circuit, Lisle's by the Fifth Circuit, and Kanter's by the Seventh Circuit. Ballard filed a writ of mandamus in the Eleventh Circuit seeking that the Tax Court be required to turn over the STJ report; the writ was denied. The Eleventh Circuit did not find anything amiss with the failure to include a copy of the STJ's report to the parties and proceeded to uphold the Tax Court's decision based on its deferential standard of review concluding that "we are not left with 'a definite and firm conviction that a mistake has been committed.'"[15]

While the Court did not directly address the deference standard to be applied to STJ reports, its analysis suggests that substantial deference by the Tax Court is critical, particularly with respect to the STJ's credibility findings.

The next of the cases to be decided by the circuit courts was with respect to the now deceased Kanter, who the Seventh Circuit pointed out "participated in countless extremely large and lucrative business ventures, reported a negative adjusted gross income each year on his federal tax return and paid no federal taxes" and had, not surprisingly, been audited by the IRS "virtually, if not literally, every year since Richard Nixon was President."[16] The Seventh Circuit concluded, as had the Eleventh Circuit, that the fact that the Tax Court's statement that the report it adopted was the STJ's rendered moot Kanter's arguments surrounding the failure to provide the STJ's report.

Seventh Circuit Judge Cudahy issued a strongly-worded dissenting opinion – cited approvingly numerous times by the Supreme Court – concluding that it was wrong for the Tax Court to withhold the STJ report from the parties. While Judge Cudahy agreed with the majority's opinion that an STJ's report was not required to be reviewed under a clearly erroneous standard, that Rule 183 was not violated if a quasi-collaborative effort takes place resulting in a revised STJ report, and that Rule 183 did not require that the STJ's report be produced, he concluded that the current Tax Court procedure violated due process.[17]

The Fifth Circuit heard Lisle's case and reversed the Tax Court's holding with respect to fraud since it concluded that the IRS did not prove its case by clear and convincing evidence.[18] With respect to the failure to provide the STJ's report to the parties, the Fifth Circuit adopted the reasoning of the Seventh and Eleventh Circuits and ruled that such failure did not violate Lisle's due process rights.[19]

THE TAX COURT

When created in 1924 as the Board of Tax Appeals, the Tax Court was an agency in the Government's executive branch.[20] In 1969 Congress formed the current Tax Court as a legislative tribunal under Article I of the Constitution.[21] Although the distinctions between Article I tribunals and Article III courts are not often evident, but often disputed, the Constitution requires Article I tribunals to be inferior to the Supreme Court, and its judges are not required to be given life tenures and salary protection as are Article III judges.[22] The Tax Court has 19 judges who are appointed by the President for 15-year terms.[23]

THE ROLE OF SPECIAL TRIAL JUDGES

STJs are specially appointed by the Chief Judge of the Tax Court to hear cases.[24] The Congressional grant of authority to appoint STJs has been upheld by the Court.[25] They earn 90 percent of a Tax Court judge's salary and "serve at the pleasure of the Tax Court [and] lack[] the independence enjoyed by regular Tax Court judges and the prerogative to publish dissenting views."[26]

THE TAX COURT RULE AT ISSUE

Tax Court Rule 183 directs that, where an STJ hears the case but the Tax Court renders the decision, the STJ "shall submit a report, including findings of fact and opinion, to the Chief Judge, and the Chief Judge will assign the case to a Judge . . . of the Court."[27] The Tax Court judge to whom the case is assigned is required to give "[d]ue regard . . . to the circumstance that the Special Trial Judge had the opportunity to evaluate the credibility of witnesses [and that the STJ's findings of fact] shall be presumed to be correct."[28]

Prior to 1983, the STJ's report was required to be served on the parties, who could file exceptions to the report. In 1983, Tax Court Rule 183(c) was amended with respect to the review of STJ reports. Since 1983, Tax Court practice has been to have the STJ and Tax Court judge "collaborate" on the decision. And, since 1983, all decisions "agree and adopt" the STJ report; no decision has been issued that modified or reversed an STJ report.

CREDIBILITY AND DEFERENCE

While the Court did not directly address the deference standard to be applied to STJ reports, its analysis suggests that substantial deference by the Tax Court is critical, particularly with respect to the STJ's credibility findings. The majority's opinion spoke of "deference" to the STJ report as being required under Rule 183, citing *Stone*[29] for the proposition that STJ findings carry "'special weight insofar as those findings are determined by the opportunity to hear and observe the witnesses,'" suggesting that *Stone* might shed some light with respect to the level of deference and its standard of review.[30] The dissenting opinion merely stated that the Tax Court had "complied with whatever degree of deference is required by Rule 183(c)."[31]

In *Stone*, the D.C. Circuit addressed the deference to be given to STJ determinations by the Tax Court under the predecessor to Tax Court Rule 183(c), Rule 182(d), which contained the identical "due regard" language of Rule 183(c). In that case, the issue was whether the corporation owned by the taxpayers or rather the taxpayers themselves were taxable on the income received by the corporation. The STJ found the taxpayers' testimony to be credible and rejected the Commissioner's position that the income was taxable to the taxpayers. The Tax Court rejected the STJ's credibility findings on the basis of the record and held that the taxpayers were taxable on the income. After noting that "the issues of scope of review often seem to have 'no more substance at the core than a seedless grape,'" the D.C. Circuit found that the Rule 182(d) language required a "relatively high level of deference," in the court's view, by a "clearly erroneous standard," it found the Tax Court's rejection of the STJ's findings to have been "clearly erroneous."[32] The IRS, however, has viewed *Stone* as erroneous on the basis that it failed to defer to the Tax Court's interpretation of its own rule.[33]

Stone addressed, but did not resolve, the thorny "multi-layered deference" issue, that is, what an appellate court should do when faced with differing decisions between the fact-finder and the intermediate reviewing body. It noted, however, that the majority view was for the court to review the fact-finder's decision, basically "drop[ping] the intermediate forum out."[34]

Interestingly, even though the taxpayers in *Stone* had pled guilty to criminal charges, the STJ found them to be credible witnesses. In reviewing the Tax

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Court's reversal of the STJ decision, the D.C. Circuit concluded that credibility (or its absence) was at the heart of the differing decisions, and it undertook to determine whether objective evidence in the record materially contradicted the taxpayers' testimony. Pyramiding the clearly erroneous standard at each level, it found that since the STJ decision was not clearly erroneous, the Tax Court was clearly erroneous in reversing the STJ's decision.

In *Kanter*, the Seventh Circuit rejected the *Stone* court's clear error requirement, stating that the adoption of such a threshold "would all but abdicate the Tax Court's original decisionmaking authority."[35] However, *Stone* provides a proper balance between review of legal issues by the Tax Court, for which *de novo* review exists, and factual findings (particularly credibility findings), which are to be given substantial deference unless objective proof exists to the contrary. Under *Stone*, the Tax Court's original decisionmaking authority remains potent, without denuding the STJ decision of those elements of review over which it has a unique perspective.

Judge Cudahy in his dissent in *Kanter* emphasized that "clearly erroneous review involves deference to the conclusions of the fact finder – the Tax Court in the present case. This is a deference that the Supreme Court has attributed, in the case of credibility, to the fact finder's firsthand observations of the witnesses in question. . . . Thus, it is integral to the standard of clear error review [which Judge Cudahy notes is "virtually indistinguishable from the substantial evidence standard"] that there be deference to the credibility findings of the official who has actually heard the witnesses."[36]

It is difficult to mesh Judge Cudahy's rejection of the requirement that the Tax Court review STJ findings on a clearly erroneous basis with continuing to recognize the primacy of the role of fact-finder. Further, as Judge Cudahy recognized, based on the Supreme Court's analysis in *Anderson v. City of Bessemer City, N.C.*,[37] "[i]f we are to give 'even greater deference' to the findings of a judge who has heard the witness whose credibility is at stake, we must inevitably give less deference to the judge who subsequently reverses those findings,"[38] giving further support to the conclusion that credibility findings are to be reviewed under a clearly erroneous standard.

In *Ballard*, the Court's rejection of the Tax Court's "idiosyncratic procedure" appeared motivated by the "outcome-influencing conclusions regarding . . . credibility"[39] that were made by the Tax Court. Additionally, the Court thought "curious" the IRS's support of the Tax Court's "concealment" of the STJ's report.[40] However, since it is generally taxpayers that have the burden of proof, credibility is more likely to be of paramount importance to taxpayers than to the IRS; in actuality it is therefore not curious at all. Perhaps that is why Justice Ginsburg never received a response from the Commissioner's counsel to her question, "aren't there situations where it might be that the special trial judge would call a credibility question in the Government's favor and then the Government loses the case before the Tax Court judge and might like to know, before it goes to the court of appeals, how solid the credibility findings were?"[41]

Credibility (or its absence) can make or break a taxpayer's case and as the Court, referring to Judge Cudahy's dissenting opinion in *Kanter,* noted "the Tax Court's current practice allows it 'very easily [to] reverse findings (credibility and otherwise) of [special trial judges] in a manner that is detrimental to the Commissioner as well as to' taxpayers."[42] While there may be instances where reversal of such findings might be warranted, departure from such findings (regardless of whether for the taxpayer or the Commissioner) should be the exception and should not occur without a reasoned explanation of the basis for the departure. Since, as the Court has recognized, "only the trial judge can be aware of the variations of demeanor and tone of voice that bear so heavily on the listener's understanding of and belief in what is said,"[43] if an explicit finding of credibility is made, due process concerns should dictate that rejections of credibility findings not be buried, particularly when another court will be reviewing the decision reversing credibility findings and will be affording such decision deference.

DUE PROCESS

The Court found that this "'extraordinary unanimity'" due to "'a collegial deliberative process'"[44] was not authorized under the Tax Court rules. Having decided the case on the basis of statutory interpretation, the Court ducked the due process issue, but suggested in dicta that if the Tax Court rules were amended to provide for the practice it rejected, it would be "subject to appellate review for consistency with the relevant federal statutes and due process."[45]

In *Kanter*, the Seventh Circuit had concluded that "secreting" the STJ's report and the Tax Court's "purportedly quasi-collaborative process would not offend our notions of fundamental fairness, nor would due process require the inclusion of the report in the appellate record to preserve the fairness of our review."[46] However, Judge Cudahy dissented and would have found a due process violation because of the absence of the STJ report in the record, because such absence precludes meaningful appellate review.[47] While Judge Cudahy would not have found a due process violation merely because of a lack of a formal degree of deference or if an issue of credibility was reversed without having actually heard the witness, he still noted that "[t]here certainly is some cause for concern that a finding of credibility on a 'cold record' as voluminous as the one before us here increases the chance of an erroneous determination."[48]

In reaching his conclusion, Judge Cudahy focused upon two Supreme Court cases, *Raddatz*, a criminal case, and *Universal Camera*, a civil case, finding them to be at opposite "end[s] of the due process spectrum.[49]

Raddatz involved a suppression hearing which the district court referred to a magistrate. Based on his credibility determinations, the magistrate found that the respondent had made voluntary inculpatory statements, and he recommended that respondent's motion to suppress be denied. The district court accepted the magistrate's recommendation without independently hearing any testimony, and respondent was tried and convicted. The Seventh Circuit concluded that the district court's failure to personally hear the witness testimony violated respondent's due process rights. The Supreme Court, focusing on the fact that the statute provided that the district court make a "*de novo* determination," not have a "*de novo* hearing," did not require (but did allow) the district judge to rehear the witnesses' testimony to comport with due process requirements. Both Justice Blackmun's and Justice Powell's concurring opinions noted that due process concerns might be implicated, however, had the district court reversed the magistrate on credibility determinations, which Justice Powell found would raise "'serious questions.'"[50] The dissenting justices would have found a due process violation in the procedure since "critical issues of credibility can be resolved only by personally hearing live testimony."[51]

On the administrative end of the due process spectrum is *Universal Camera*. In *Universal Camera* the National Labor Relations Board ("NLRB") reversed the examiner's findings. The Second Circuit

While it may be expedient for tax tribunals to dismiss the applicability of *Ballard* as a procedural aberration particular to the Tax Court, the decision highlights how easy it is for tax tribunals to push the procedural envelope to the detriment of taxpayers' due process rights.

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determined that it was bound to follow the NLRB and could not consider the examiner's report. The Court reversed and found that "the courts must now assume more responsibility for the reasonableness and fairness of [NLRB] decisions than some courts have shown in the past,"[52] and that courts "accord the findings of the trial examiner the relevance that they reasonably command in answering . . . whether the evidence supporting the [NLRB's] order is substantial."[53]

Interestingly, the IRS argued that a non-Article III forum does not need to afford as high a degree of procedural due process protection as that which must be given by an Article III court, and the mere ability of the Tax Court to "receive further evidence" provides sufficient protection under *Raddatz*.[54] However, given the considerable overlap between Article III courts, Article I tribunals, and administrative agencies, the criminal versus civil differentiation may be a more relevant inquiry. Further, as *Ballard* and numerous other Court decisions suggest, even if substantial deference to credibility findings were not constitutionally compelled, substantial deference to such findings is the only right result.[55]

BALLARD'S LESSONS FOR STATE TAX TRIBUNALS AND COURTS

While it may be expedient for tax tribunals to dismiss the applicability of *Ballard* as a procedural aberration particular to the Tax Court, the decision highlights how easy it is for tax tribunals to push the procedural envelope to the detriment of taxpayers' due process rights. The Court understood that the role of the STJ was analogous to that of an administrative law judge.[56] Time and again, uncontroverted testimony explicitly found by triers of fact to be credible is dismissed without explanation or as "self-serving." However, as the D.C. Circuit Court aptly acknowledged in *Stone*, a person's testimony "is almost by definition self-serving."[57] Therefore, the oft-heard lament from tax officials that a taxpayer's testimony (or that of its witnesses) is self-serving may be a truism, but adds nothing to the determination as to whether or not the testimony is credible.

Decisions are often drafted with an eye toward supporting the desired holding instead of providing a balanced, accurate recitation of the facts. The Court understood the "well-founded, commonly accepted understanding: The officer who hears witnesses and sifts through evidence in the first instance will have a comprehensive view of the case that cannot be conveyed full strength by a paper record."[58] A trial judge's decision – like the STJ's report – is not an "'in-house draft to be worked over collaboratively'"[59] or, worse, ignored by a reviewing tribunal as a mere suggestion that can be rejected without ample, objective bases. However, "judicial independence in the context of due process is not a principle to be taken lightly, and its absence has consequences."[60]

Further, it would be wise for tribunals reviewing trial judges' decisions to remember that trial judges' main role is to determine facts and "the trial on the merits should be 'the main event' . . . rather than a 'tryout on the road,'" that is, having established the facts before a trial judge, unless objective evidence is contrary to a witness's testimony or such testimony is so fundamentally incredible as not to be believed, the party should not be required to again persuade the reviewer; "deference to the trier of fact – is the rule, not the exception."[61]

Additionally, when a court is faced with appellate review of a decision that reversed the trial judge's factual findings, its scrutiny of such reversal should be heightened, since the "evidence supporting a conclusion may be less than substantial when an impartial, experienced examiner who has observed the witnesses and lived with the case has drawn conclusions different from the [reviewing tribunal's] than when he has reached the same conclusion."[62] The right to appeal is no substitute for the "meaningful" and "effective" appellate review required to comport with due process.[63] If the appellate review gives little scrutiny to reversals of credibility findings by those who have not had the opportunity to hear the witnesses, one is hard-pressed to conclude that appellate review has met fundamental notions of fairness, which is one of the hallmarks of due process.

Finally, as Judge Cudahy appropriately recognized, even if no actual impropriety occurs, transparency in the process would protect the Tax Court from the "perception that an STJ's 'findings' are arbitrarily malleable at the discretion of the Tax Court."[64] That recognition should govern all tax administration processes. Tax administration systems work best when all parties – particularly the taxpayers – believe that the system operates fairly, openly, and objectively and they are not merely going through a futile exercise toward a foregone conclusion. Replacing internal tax review systems with independent tax review systems goes a long way in the right direction. It is evident from the transcript of the oral argument in *Ballard*, as well as the tone and holding of the Court's decision, that the Court wholeheartedly agreed that the appearance of impropriety is troubling even if no actual impropriety exists. Having individuals employed by the same agency that issues the assessments review the assessments does not pass the Court's smell test. *Ballard* suggests that tax administration systems that do not toe the line will – as they should – be called to task. ■

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[1] *Unwired Telecom Corp. v. Parish of Clacasieu*, 903 So. 2d 392, 401 (La. 2005) (citations omitted).

[2] *Ballard v. Commissioner*, 544 U.S. ___, 125 S. Ct. 1270 (2005). Justice Rehnquist wrote the dissenting opinion, joined by Justice Thomas.

[3] *Ballard*, 125 S. Ct. at 1284.

[4] *Ballard v. Commissioner*, 321 F.3d 1037, 1038 (11th Cir. 2003).

[5] Brief on the Merits at 12, *Ballard* (No. 03-184).

[6] Brief for the Petitioners at 9, *Kanter* (No. 03-1034).

[7] Brief on the Merits at 5, *Ballard* (No. 03-184).

[8] *Id.* at 12.

[9] Brief for the Petitioners at 6a, *Kanter* (No. 03-1034).

[10] *Id.*

[11] *Ballard*, 321 F.3d at 1040.

[12] *Id.* at 1041.

[13] Brief for the Petitioners at 14, n.11, *Kanter* (No. 03-1034).

[14] 26 U.S.C. § 7482(b)(1)(A).

[15] *Ballard*, 321 F.3d at 1044 (citation omitted).

[16] *Estate of Kanter v. Commissioner*, 337 F.3d 833, 838 (7th Cir. 2003).

[17] *Id.* at 888.

[18] *Estate of Lisle v. Commissioner*, 341 F.3d 364 (5th Cir. 2003).

[19] *Id.* at 384.

[20] Revenue Act of 1924, ch. 234, § 900(h), 43 Stat. 337.

[21] Tax Reform Act of 1969, Pub. L. No. 91-172, § 951, 83 Stat. 730.

[22] U.S. Const. art. I, § 8, cl. 9; art. III, § 1; James E. Pfander, *Article I Tribunals, Article III Courts, and the Judicial Power of the United States*, 118 Harv. L. Rev. 643 (2004).

[23] 26 U.S.C. § 7443(a), (b) & (e).

[24] 26 U.S.C. § 7443A(a).

[25] *Freytag v. Commissioner*, 501 U.S. 868 (1991).

[26] 26 U.S.C. § 7443A(d); *Ballard*, 125 S. Ct. at 1276, 1285.

[27] Tax Ct. Rule 183(b).

[28] Tax Ct. Rule 183(c).

[29] *Stone v. Commissioner*, 865 F.2d 342 (D.C. Cir. 1989).

[30] *Ballard*, 125 S. Ct. at 1280.

[31] *Id.* at 1289-90 (dissent).

[32] *Stone*, 865 F.2d at 344, 345 (citation omitted).

[33] Brief for the Respondent at 28 n.6, *Ballard* (No. 03-184 and 03-1034).

[34] *Stone*, 865 F.2d at at 347.

[35] *Kanter*, 337 F.3d at 841.

[36] *Id.* at 884-85 (Cudahy, J., dissenting).

[37] 470 U.S. 564 (1985).

[38] *Kanter*, 337 F.3d at 885 (Cudahy, J., dissenting).

[39] *Ballard*, 125 S. Ct. at 1283, 1285.

[40] *Id.* at 1284 n.15.

[41] *Id.* at 1284 n.15; Transcript of Oral Argument at 28, *Ballard* (No. 03-184).

[42] *Ballard*, 125 S. Ct. at 1284 n.15 (citation omitted).

[43] *Anderson*, 470 U.S. at 575.

[44] *Ballard*, 125 S. Ct. at 1281 (citations omitted).

[45] *Id.* at 1286.

[46] *Kanter*, 337 F.3d at 841.

[47] *Id.* at 888 (Cudahy, J., dissenting).

[48] *Id.* at 883 (Cudahy, J., dissenting).

[49] *Id.* at 882 (Cudahy, J., dissenting) (citing *United States v.Raddatz*, 447 U.S. 667 (1980); *Universal Camera Corp. v. NLRB*, 340 U.S. 474 (1951)).

[50] *Raddatz*, 447 U.S. at 686 (citation omitted).

[51] *Id.* at 691, n.5.

[52] *Universal Camera*, 340 U.S. at 490.

[53] *Id.* at 497.

[54] Brief for the Respondent at 36-39, *Ballard* (Nos. 03-184 and 03-1034).

[55] *See, e.g., Anderson*, 470 U.S. at 575 ("only the trial judge can be aware of the variations of demeanor and tone of voice that bear so heavily on the listener's understanding of and belief in what is said"); *Goldberg v. Kelly*, 397 U.S. 254, 269 (1970) ("where credibility and veracity are at issue . . . written submissions are a wholly unsatisfactory basis for decision"); *Holiday v. Johnston*, 313 U.S. 342, 352 (1941) ("[o]ne of the essential elements of the determination of the crucial facts is the weighing and appraising of testimony"); *Morgan v. United States*, 298 U.S. 468, 481 (1936) ("[t]he one who decides must hear").

[56] Transcript of Oral Argument (Breyer, J.) at 16, *Ballard* (No. 03-184).

[57] *Stone*, 865 F.2d at 344.

[58] *Ballard*, 125 S. Ct. at 1283.

[59] *Id.* at 1281.

[60] *Kanter*, 337 F.3d at 887 (Cudahy, J., dissenting).

[61] *Anderson*, 470 U.S. at 575.

[62] *Universal Camera*, 340 U.S. at 496.

[63] *Evitts v. Lucey*, 469 U.S. 387, 393 (1985).

[64] *Kanter*, 337 F.3d at 880 (Cudahy, J., dissenting).
