

Supreme Court Jurisprudence of Tax Fairness

*Richard J. Wood**

“People want *just* taxes more than they want *lower* taxes.”
–Will Rogers¹

I. INTRODUCTION	421
II. TAX FAIRNESS NORMS	424
III. SYSTEMIC OR ADMINISTRATIVE FAIRNESS	430
A. Statute of Limitations and Horizontal Equity	431
B. Development of Systemic Horizontal Equity Beyond Statute of Limitations Cases	441
IV. THE ROLE OF FAIRNESS IN STATUTORY CONSTRUCTION	445
V. TAX FAIRNESS AS A COMPONENT OF CONSTITUTIONAL EQUAL PROTECTION	455
VI. THE ROLE OF FAIRNESS IN INTERPRETING TAX ISSUES UNDER THE COMMERCE CLAUSE OF THE UNITED STATES CONSTITUTION	466
A. Tax Fairness, Horizontal Equity, and the Commerce Clause	468
B. Tax Fairness, Vertical Equity, and the Commerce Clause	470
VII. CONCLUSION.....	477

I. INTRODUCTION

In *Wealth of Nations*, Adam Smith offered his views on tax fairness. “The subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities; that is, in proportion to the revenue which they respectively enjoy under the protection of the state.”² This view

* Professor of Law, Capital University Law School.

¹ LAURENCE J. PETER, *PETER’S QUOTATIONS: IDEAS FOR OUR TIME* 464 (William Morrow & Co. 1977).

² ADAM SMITH, *WEALTH OF NATIONS* 498 (Prometheus Books 1991) (1776). Smith also offered three other observations about fair tax systems:

II. The tax which each individual is bound to pay ought to be certain, and not arbitrary. The time of payment, the manner of payment,

that fairness requires a proportional link between tax and taxpayer income is known as the benefit principle.³ It and other views of tax equity, including the equal sacrifice principle, the standard of living principle, and the ability to pay principle, can be seen as subordinate to a superior tax fairness structure that is comprised of two fairness norms. That structure is known collectively as vertical and horizontal equity.⁴ These two tax fairness principles are corollaries of each other:⁵

First, we can postulate a kind of bedrock notion of tax fairness, called *horizontal equity*, which yields the following maxim: *like-situated taxpayers should be taxed the same*. It's hard to disagree with that.

Now, if some people are like-situated, the rest must be differently situated, and it cannot be correct to say that people who are differently situated (relative to me) should be taxed the same as

the quantity to be paid, ought all to be clear and plain to the contributor, and to every other person. . . .

III. Every tax ought to be levied at the time, or in the manner, in which it is most likely to be convenient for the contributor to pay it. . . .

IV. Every tax ought to be so contrived as both to take out and to keep out of the pockets of the people as little as possible, over and above what it brings into the public treasury of the state.

Id. at 499.

³ See LIAM MURPHY & THOMAS NAGEL, *THE MYTH OF OWNERSHIP: TAXES AND JUSTICE* 16 (Oxford Univ. Press 2002). The benefit principle reflects the view “[t]hat fairness in taxation requires that taxpayers contribute in proportion to the benefit they derive from government.” *Id.* Murphy and Nagel think that this view should be rejected along with other pre-distributive concepts of fairness including horizontal and vertical justice. “The benefit principle, however, cannot be saved from incoherence It is inconsistent with every significant theory of social and economic justice.” *Id.* at 19. See also Leo P. Martinez, “*To Lay and Collect Taxes*”: *The Constitutional Case For Progressive Taxation*, 18 YALE L. & POL’Y REV. 111, 123 (1999) (“Benefit theory is divided into two arguments, ‘property benefits’ and ‘income-equals-benefit.’”). Although he predates Murphy and Nagel, Professor Martinez’s discussion of these two ways of looking at benefit theory help explain the distributive justice concerns raised by Murphy and Nagel. According to Professor Martinez, “[t]he ‘property benefits’ argument suggests that, although personal benefits are roughly uniform, the amount of property benefits rises with the amount of property owned. . . . The ‘income-equals-benefit’ argument suggests that personal income is the measure of the ‘personal well-being’ that the government protects.” *Id.*

⁴ See MURPHY & NAGEL, *supra* note 3, at 13 (“Everyone agrees that taxation should treat taxpayers equitably, but they don’t agree on what counts as equitable treatment. It is standard practice in addressing the question to distinguish between vertical and horizontal equity. According to this conception, vertical equity is what fairness demands in the tax treatment of people at different levels of income . . . ,and horizontal equity is what fairness demands in the treatment of people at the same levels.”).

⁵ See JOSEPH M. DODGE ET AL., *FEDERAL INCOME TAX: DOCTRINE, STRUCTURE, AND POLICY* 120–27 (3d ed. 2004).

me. Rather, *differently situated people should be taxed differently*. This maxim is known as *vertical equity*.⁶

These two norms, horizontal and vertical equity, stated as one principle with two important divisions, have long been used to evaluate the fairness of tax legislation.⁷ Most published work on tax fairness has focused on these two norms and the four views of tax justice in the political (legislative) context rather than the judicial.⁸ My concern is that the tax structure of horizontal and vertical equity, within which the principles mentioned above and others may compete for acceptance, ought to be reflected in the United States Supreme Court's tax decisions.

My thesis is that the Court uses systemic, but not substantive, tax fairness norms to classify taxpayers as similarly situated to each other and the government. Further, a trend is developing in the Court's Commerce Clause and tax fairness jurisprudence: the Court has become more willing to consider distributive justice principles in the context of vertical tax equity. My research shows that the Court has refined horizontal equity into what I call systemic and substantive branches. Furthermore, the Court's use of vertical equity suggests a starting point for future application of distributive justice principles in Supreme Court tax fairness jurisprudence.

I have organized this Article by focusing on three areas in which the Court has used tax fairness norms in resolving tax disputes: tax administration, statutory construction, and state taxation tested against the Equal Protection and Commerce Clauses of the United States Constitution. In reviewing the materials,⁹ I found that the

⁶ *Id.* at 122.

⁷ Martinez, *supra* note 3, at 116 (“[C]rafting a system of taxation that results in a fair distribution has proven to be a daunting task. In their attempt to achieve a fair distribution of the tax burden, tax policy-makers rely on two crude principles: horizontal equity and vertical equity.”).

⁸ See *Kenseth v. Comm’r*, 259 F.3d 881, 885 (7th Cir. 2001) (characterizing “equity in taxation [as] being a political rather than a jural concept”).

⁹ To determine the scope, extent, and manner of use of tax fairness norms, I searched for decisions of the United States Supreme Court in which the Court employed fairness principles in resolving tax controversies. The process I used was a simple word search in a commercial Supreme Court database. I looked for cases in which the term “tax” was linked to terms such as “fairness” or “equity.” I then selected those cases that I thought best represented the Court’s jurisprudence in applying tax fairness norms. Finally, I compared the Court’s use of tax fairness norms to generally accepted legislative tax fairness analysis. In this way I hoped to determine whether the principles used to guide legislation can be seen reflected in the final outcomes of tax controversies at the Supreme Court level.

Some decisions in which the Court used the word “fairness” in connection with a tax dispute were rejected and not included in my analysis. This exclusion of cases

Court employs both vertical and horizontal equity norms as well as subordinate equity principles such as the benefit principle and the ability to pay principle in resolving tax disputes. I start by explaining the tax fairness norms observed in the cases reviewed. I then show how the least controversial norm, horizontal equity, was developed early by the Court and expanded over time. I next show that the Court divided horizontal equity into two branches. One branch, systemic horizontal equity, evaluates similarity without resort to content. In other words, the Court does not consider ability to pay measured by income, wealth, or consumption when using this branch of horizontal equity. Instead, analysis under systemic horizontal equity is concerned primarily with consistency and, to a lesser degree, regularity and certainty of application. The second branch of horizontal equity, substantive horizontal equity, uses ability to pay as the primary criterion for grouping similarly situated taxpayers. The evolution of vertical tax equity and the related points of the benefit principle and the ability to pay principle are also addressed in this Article.

II. TAX FAIRNESS NORMS

The literature on tax fairness discusses two structural methods for analyzing the fairness of federal income tax questions: equity measured along vertical and horizontal axes. Equity measured horizontally and vertically can be succinctly stated as requiring that similarly situated taxpayers must be treated alike and that differently situated taxpayers must be treated in ways that reflect their differences.

There is very little debate about whether horizontal equity should be considered a tax policy norm.¹⁰ The principle that similarly situated taxpayers should be treated similarly is neither new nor controversial. As is so often true in matters of tax, however, the diffi-

occurred primarily because the Court did not explain what it meant by the fairness terms it used or because the explanation, or implicit but unstated fairness claim, was better or more completely developed in other decisions. From the group of cases that remained I uncovered other cases in which the Court did not use the term "fairness," but did use equity norms in resolving the tax issues presented in the case. Pursuant to this approach I was left with a group of cases that addressed tax fairness issues in three contexts: tax administration, statutory construction, and state taxation tested against the Equal Protection and Commerce Clauses of the U.S. Constitution. These three subgroups are linked by the Court's application of tax fairness principles.

¹⁰ Richard A. Musgrave, *Equity and the Case for Progressive Taxation*, in TAX JUSTICE: THE ONGOING DEBATE 9, 9 (Joseph J. Thorndike & Dennis J. Ventry Jr. eds., 2002) ("The principle of horizontal equity—that people in equal positions should be treated equally—is hardly debatable.").

culty arises in the application of the norm rather than in its definition. The primary concern centers on the criteria that should be used to determine whether taxpayers are similarly situated. No two taxpayers are exactly alike. Consider for example two wage-earners working side-by-side for exactly the same compensation. Leaving aside personal issues such as marital status or number of dependants and focusing exclusively on work-related issues, the taxpayers may still have significant differences that prevent them from being treated exactly alike. One might incur deductible employment-related expenses such as uniform laundering fees or continuing professional education that the other does not.¹¹ The question may then become one of materiality.¹² In other words, are the similarities strong enough in some relevant way to overcome any differences that exist between the taxpayers?

One of the components of horizontal equity is an analysis of the commonalities between taxpayers. This analysis leads to identifying whether these commonalities are material and sufficiently similar to warrant similar treatment. Material and sufficient similarity would both be required. Taxpayers who are alike in material ways may nonetheless have differences in scale that overpower the initial finding of similarity. The taxpayers in the above illustration may be alike in that they both incur employment-related business expenses associated with continued professional education for their identical professional positions. If Taxpayer *A* elects to take her professional classes from a school that charges her \$1,000, while Taxpayer *B* takes the same classes from a school that charges \$10,000, we may need to refine our criteria for similarly situated taxpayers. We may find, for example, that the difference in price reflects an education-related item such as class size, a tangentially related item such as computer study aids, or additional unrelated expenses such as the provision of meals. Presented with these possibilities, we would have to decide whether Taxpayers *A* and *B* should be treated similarly. In other words, we would have to determine whether both would be able to deduct the full cost of their tuition. This, in turn, might depend on whether the differences in cost were due to material factors, such as

¹¹ Employment-related expenses of this type are known as employee business expenses and are deductible under I.R.C. § 162 (2000) subject to the limitations of I.R.C. § 67 (2000). See also I.R.C. § 62(a)(2) (2000) (reimbursed employee business expenses).

¹² See DODGE ET AL., *supra* note 5, at 122 (“Once it is acknowledged that not every person is like-situated, it is necessary to come up with a ‘difference principle,’ a way of telling whether people are alike or different, and, if different, by what degree different . . .”).

class size or information technology, or immaterial factors such as lavishly catered meals.

It may be that there is only one axis for horizontal equity and the distinctions I raise are merely slicing the materiality component into increasingly slimmer sections. It may be, however, that materiality is the first cut and further refinements are on a different axis. Materiality may refer to whether the taxpayer is in a class of taxpayers entitled to a particular treatment, such as those who incur employee business expenses. The magnitude of the benefit or burden imposed on that class, however, may be a separate question that no longer requires consideration of whether the taxpayer is entitled to be treated similarly to other taxpayers, but rather the extent to which the taxpayer benefits or pays within the class of similarly identified taxpayers.

My reading of the cases is that the Court adopts the former view expressed above. I believe that the Court would see the first two distinctions (class size or computer study aids) raised in the employee business expense illustration as further refinements of material differences rather than separate questions measured along another axis. The difference in education expense due to educational costs is likely to be seen as immaterial whereas the difference in expense due to costs unrelated to education is likely to be seen as material. These material differences distinguish taxpayers who are entitled to deduct amounts paid for education and those who are prohibited from deducting amounts paid that are not for education. Accordingly, expenses for meals that were folded into distinctions based upon educational costs would not be permitted under horizontal equity analysis.

The foregoing paints the standard picture of horizontal equity. I would like to further refine the concept by dividing this standard approach into what I will call substantive horizontal equity and systemic horizontal equity. The Court views these two components as distinct and often applies one while declining to apply the other. In the above described illustration, I believe that the Court would not use ability to pay in determining which taxpayers are similarly situated. Rather, the Court would analyze the tax fairness of allowing one taxpayer a deduction for education expenses while denying the same deduction to another by examining consistency, regularity, or certainty of application, and not by examining the taxpayers' ability to pay, consumption, or wealth. In other words, the Court would ask whether any of the taxpayers incurred expenses within a consistently defined boundary called educational expenses. So long as the Commissioner of Internal Revenue was consistent in applying a

reasonable definition of educational expenses, the Court would uphold the Commissioner's definition even if taxpayers with identical income, wealth, or consumption were treated differently. This, in my view, is an application of systemic horizontal equity.

Historically, commentators have studied the fairness of any tax burden in any tax system (income, estate, sales) by first determining whether it falls equally on taxpayers of similar income, wealth, or consumption.¹³ If, for example, one wanted to know whether a ten percent tax on the sale of alcohol would be fair, one would want to know whether taxpayers who consume equal amounts of alcohol were taxed equally. Fairness requires equally situated taxpayers to be taxed equally. The main issue is identifying what should be considered in determining which taxpayers are equally situated. If consumption of alcohol is the measure of equality, then the tax would be fair because every taxpayer would pay a ten percent tax on every dollar used to purchase alcohol. If, however, the measuring tool is income, then the tax burden will be born more heavily by those who use a high percentage of their income to purchase alcohol, even if the actual amounts of alcohol consumed are identical.¹⁴ This form of tax equity analysis, termed substantive horizontal equity, evaluates the substantive economic status of taxpayers as measured by consumption, income, or wealth, and is different from another form of horizontal equity analysis that does not evaluate the economic status of taxpayers. This second form of horizontal equity analysis, termed systemic horizontal equity, does not evaluate the economic status of taxpayers, but instead evaluates the consistency, certainty, and regularity of application of the law.

Substantive horizontal equity asks about all of the above described issues in the context of comparing various taxpayers' ability to

¹³ See John A. Miller, *Rationalizing Injustice: The Supreme Court and the Property Tax*, 22 HOFSTRA L. REV. 79, 126 (1993) ("Depending on the form of tax in question, the possible indices of equality may be income, consumption or wealth.").

¹⁴ If the tax on alcohol is five percent, and Taxpayer A with \$60,000 of annual income consumes \$600 worth of alcohol in one year, she will pay \$30 in tax—0.05% of her income. If Taxpayer B with \$120,000 of annual income also consumes \$600 of alcohol, she will pay the same \$30 in tax, but it will be a smaller burden when compared to her annual income—only 0.025%. Accordingly, if the two are compared on the basis of consumption, they are similarly situated and similarly treated, and thus, the tax would be viewed as fair. If percent of income is the measure of fairness, then the tax can be criticized as unfair since Taxpayer A carries twice the burden of Taxpayer B, despite the fact that they both consumed \$600 worth of alcohol. Thus, similarly situated taxpayers are being taxed differently as to the percent of their income. See ALAN GUNN & LARRY WARD, CASES, TEXT AND PROBLEMS ON FEDERAL TAXATION 10 (West 5th ed. 2002).

pay in the forms of income, wealth, and consumption.¹⁵ Systemic horizontal equity is related to substantive horizontal equity in that both look for similarly situated parties, but systemic horizontal equity does not ask any questions about economic status as measured by consumption, wealth, or ability to pay. Instead, systemic horizontal equity is more concerned with whether taxpayers, and the government, receive consistent, regular, and certain treatment under the law.¹⁶ Through a series of decisions, the Court has come to endorse systemic horizontal equity as a tool for interpreting tax laws. In two related cases concerning state property tax, the Court declined the opportunity to employ substantive horizontal equity in interpreting state tax laws.¹⁷

A great deal of the energy of modern tax fairness thinking has been directed at analyzing whether vertical equity is a valid component of tax fairness. Vertical equity is essentially identified with the taxation of incomes at different rates with the higher rates reserved for higher incomes.¹⁸ The leading treatise on this point is *The Uneasy Case for Progressive Taxation* by Walter J. Blum and Harry Kalven, Jr.¹⁹ The central question addressed is: "On what grounds is a progressive tax on income to be preferred to a proportionate tax on income?"²⁰ Blum and Kalven defend progressive taxation based upon the principle of equality of sacrifice of taxpayers as measured by a theory of the marginal utility of money.²¹ In the authors' words, "Assuming a dollar is worth less to the man with the larger income than to the man with the smaller income, a dollar taken from the former will involve

¹⁵ See *supra* note 13 and accompanying text.

¹⁶ See *Ivan Allen Co. v. United States*, 422 U.S. 617, 641 (1975) (Powell, J., dissenting). This case concerned a corporate taxpayer who was assessed accumulated earnings taxes under I.R.C. § 531. *Id.* at 620–21 (majority opinion). The Court found that the taxpayer must value readily marketable securities at their market value rather than cost basis in determining whether the taxpayer is liable for accumulated earnings tax. *Id.* at 629. Justice Powell in dissent characterized the holding as follows: "In short, the Court construes the statute to mean that although unrealized appreciation is not included in computing earnings and profits, it is includable in determining whether earnings and profits have been accumulated unreasonably." *Id.* at 639 (Powell, J., dissenting). Justice Powell goes on to recommend that the Court adopt principles of sound accounting practice that "have the virtues of consistency, regularity and certainty—virtues that also assure fairness and reasonable predictability in the Commissioner's administration of this penalty tax." *Id.* at 641.

¹⁷ *Allegheny Pittsburgh Coal Co. v. County Comm'n* 488 U.S. 336 (1989); *Nordlinger v. Hahn*, 505 U.S. 1 (1992).

¹⁸ Donna M. Byrne, *Progressive Taxation Revisited*, 37 ARIZ. L. REV. 739, 759 (1995).

¹⁹ WALTER J. BLUM & HARRY KALVEN, JR., *THE UNEASY CASE FOR PROGRESSIVE TAXATION* (4th impression, Univ. of Chicago Press 1963).

²⁰ *Id.* at 3.

²¹ *Id.* at 49–51.

less sacrifice than one taken from the latter.”²² But some, including Blum and Kalven, question whether the marginal utility of income falls with rising income and whether different individuals will derive equal utility from similar incomes.²³

This criticism can be illustrated by considering two groups of individuals. One group might be comprised of a set of entrepreneurs who greatly value every dollar they earn as a sort of tally in a game played with other similarly inclined entrepreneurs; perhaps Donald Trump might be emblematic of this group. Consider next a group of spiritually fulfilled individuals with no interest in earthly units of money; perhaps the late Mother Theresa might represent this group. To the entrepreneurs, the utility of money might rise with rising incomes as they overtake other players in their pursuit of recognition for their economic prowess. Similarly, the utility of money for the spiritual person might remain constant, above subsistence levels, and therefore also not be supportive of a model of declining utility of money.

From these two groups we might infer that marginal utility of money may not decline with increasing income and that there is no agreement on equality of utility of money between the groups and thus between individuals. Blum and Kalven concede that there is uncertainty in the calculus of utility, but they claim:

However uncertain other aspects of progression may be, there is one thing about it that is certain. A progressive tax on income necessarily operates to lessen the inequalities in the distribution of that income. In fact, as we noted at the outset, progression cannot be defined meaningfully without reference to its redistributive effect on wealth or income. It would seem therefore that any consideration of progression must at some time confront the issue of equality.²⁴

Current scholarship infused the debate about vertical equity with theories of distributive justice.²⁵ While the cases I reviewed do not explicitly address distributive justice claims, they do lay the ground-

²² *Id.* at 51.

²³ *Id.* at 53 (“The assumption is that the utility of the last dollar taken in taxes is independent of the total dollars the taxpayer had before taxes. It may be true that to take \$2 from a man with \$5,002 and to take none from a man with \$5,000 entails less total sacrifice than taking \$1 from each; but surely it is highly debatable that this is true if in the example the richer man had an income of \$10,000, had grown accustomed to this standard of living, and for the first time \$4,998 in taxes had just been taken from him.”).

²⁴ *Id.* at 70.

²⁵ See Linda Sugin, *Theories of Distributive Justice and Limitations on Taxation: What Rawls Demands From Tax Systems*, 72 *FORDHAM L. REV.* 1991 (2004).

work for beginning the discussion. The Court has developed a body of work that describes governmental benefits that may be considered in evaluating whether a taxpayer is paying his or her fair share of the costs of those benefits. That is a starting point for evaluating whether there has been a distribution of wealth through benefits and taxation.

Blum and Kalven might have predicted that the Supreme Court would need to address notions of connectivity between benefits and taxes because they understood taxes not to be “one-sided transfer[s].”²⁶ No one disagrees that to some extent taxpayers can be seen to purchase benefits with the taxes they pay.²⁷ The question becomes the degree of congruity between taxes paid and value received. This is another way of asking what counts as a benefit. One method for evaluating benefits and their relationship to taxes is to attempt to quantify the value of government services received by taxpayers. Another method would be to use income or wealth as a proxy for that value.²⁸ The Supreme Court, in several cases addressing state taxation of out-of-state taxpayers, began the difficult task of connecting governmental services to taxes paid by those who benefit from the services.²⁹

III. SYSTEMIC OR ADMINISTRATIVE FAIRNESS

One of the first applications of fairness principles to tax questions arose in procedural due process claims, brought by taxpayers, that focused on tax statutes of limitations. One case concerned the retroactivity of tax legislation in which the Court raised fairness concerns *sua sponte*.³⁰ In the other case, the Court let stand lower court decisions concerning the fairness of unequal treatment of a taxpayer, who filed a fraudulent return followed by a non-fraudulent return, and claimed to be similarly situated with taxpayers who file non-fraudulently without previously filing fraudulently.³¹ In each case, the Court takes up fairness questions in the context of statutes of limitations and provides illustrations and applications of discrete principles of fairness.

²⁶ BLUM & KALVEN, *supra* note 19, at 35.

²⁷ *Id.*

²⁸ *Id.* at 35–39; *see also* Martinez, *supra* note 3, at 123 (“The ‘income-equals-benefit’ argument suggests that personal income is the measure of the ‘personal well-being’ that the government protects.”).

²⁹ *See infra* Section VI.

³⁰ Rothensies v. Electric Storage Battery Co. (*Electric Storage Battery IV*), 329 U.S. 296 (1946).

³¹ Badaracco v. Comm’r, 464 U.S. 386 (1984).

A. *Statute of Limitations and Horizontal Equity*

Tax statutes of limitations were at issue in both *Rothensies v. Electric Storage Battery Co.*³² and *Badaracco v. Commissioner*.³³ In *Electric Storage Battery*, the taxpayer paid federal excise taxes on the sale of electric storage batteries from 1919 to 1926 and properly deducted the amount paid in excise taxes from its income in determining its income tax liability.³⁴ The taxpayer brought suit for refund of the excise taxes.³⁵ In 1935, the government repaid the taxpayer over one million dollars in settlement of a judgment of the United States District Court with respect to the excise taxes.³⁶ The period from 1919 to 1922 was not part of the judgment or the settlement because it was barred by the statute of limitations from the action in the district court. The Collector of Internal Revenue, Mr. Rothensies, treated the settlement received by the taxpayer in 1935 as income for that year.³⁷ The taxpayer claimed that based upon a theory of recoupment the taxpayer should be allowed to reduce the amount of income tax owed by the amount of excise tax it overpaid for the years 1919 to 1922.³⁸ In other words, the taxpayer wanted credit for taxes incorrectly paid but which were non-refundable due to the passage of time and the application of the statute of limitations.

³² 329 U.S. 296 (1946).

³³ 464 U.S. 386 (1984).

³⁴ In the first of a series of cases, *Electric Storage Battery Co. v. McCaughn (Electric Storage Battery I)*, 52 F.2d 205, 210 (E.D. Pa. 1931), the taxpayer successfully sued for the recovery of excise taxes paid on batteries manufactured by the taxpayer. The district court awarded the taxpayer \$973,532.57 plus interest, totaling \$1,362,861.27. *Id.* The taxpayer then settled his claim with the IRS for \$825,151.52 plus interest, for a total of \$1,395,515.35. *Electric Storage Battery Co. v. Rothensies (Electric Storage Battery II)*, 57 F. Supp. 731, 732 (E.D. Pa. 1944); *see also, Electric Storage Battery*, 329 U.S. at 298. The taxpayer then sued to recover income taxes paid in 1935 based upon a claim for recoupment of excise taxes paid from 1919 to 1922, which the district court granted. *Electric Storage Battery II*, 57 F. Supp. at 732. The Third Circuit agreed, *Electric Storage Battery Co. v. Rothensies (Electric Storage Battery III)*, 152 F.2d 521, 526 (3d Cir. 1945), but the Supreme Court reversed. *Electric Storage Battery IV*, 329 U.S. at 303.

³⁵ *Electric Storage Battery II*, 57 F. Supp. at 731.

³⁶ *Electric Storage Battery III*, 152 F.2d at 522. The taxpayer was awarded a refund of \$973,532.57 in excise tax overpayment, plus interest. In *Electric Storage Battery I*, the taxpayer settled the claim for a refund of \$825,151.52 in excise tax, plus interest. 52 F.2d at 210.

³⁷ *Electric Storage Battery IV*, 329 U.S. at 298. The District Court, the Court of Appeals, and the Supreme Court agreed that the amount was income in the year received by the taxpayer. *Id.*

³⁸ *Id.*

The taxpayer's claim was based upon the Supreme Court's decision in *Bull v. United States*,³⁹ which held that taxpayers may assert a claim for recoupment against a government claim for unpaid taxes when the taxpayer's claim "aris[es] out of some feature of the transaction upon which the [government's] action is grounded."⁴⁰ Contrary to the government's view, the Court of Appeals for the Third Circuit applied the doctrine by defining "transactions" to include those arising out of a single line of business that extended over different tax years. The court held:

The doctrine of recoupment is based on concepts of fairness. We see no reason, therefore, for hedging the "transaction" part of the requirement within close quarters, especially where, as here, there is a logical connection between main claim and recoupment claim. As to the fairness of the matter, we agree with the District Court where his opinion stated: "Every consideration of fair dealing demands that the taxpayer be credited as against its present liability with the taxes which it has been illegally compelled to pay, and I think that the decisions of the courts fully justify such a solution."⁴¹

The Supreme Court agreed that the taxpayer's position was grounded on valid fairness principles, but nevertheless, ruled against the taxpayer:

It probably would be all but intolerable, at least Congress has regarded it as ill-advised, to have an income tax system under which there never would come a day of final settlement and which required both the taxpayer and the Government to stand ready forever and a day to produce vouchers, prove events, establish values and recall details of all that goes into an income tax contest. Hence a statute of limitation is an almost indispensable element of fairness as well as of practical administration of an income tax policy.

....

As statutes of limitation are applied in the field of taxation, the taxpayer sometimes gets advantages and at other times the Government gets them. Both hardships to the taxpayers and losses to the revenues may be pointed out. They tempt the equity-minded judge to seek for ways of relief in individual cases.⁴²

³⁹ 295 U.S. 247 (1935).

⁴⁰ *Id.* at 262.

⁴¹ *Electric Storage Battery III*, 152 F.2d at 524 (quoting *Electric Storage Battery II*, 57 F. Supp. at 735).

⁴² *Electric Storage Battery IV*, 329 U.S. at 301-02.

The Court of Appeals characterized the taxpayer's recoupment claim as required by "consideration[s] of fair dealing."⁴³ The government claimed, and the Supreme Court ultimately agreed, that a statute of repose is an "almost indispensable element of fairness" in the administration of income tax.⁴⁴ The Court did not specifically say why the government's fairness claim was found to be superior to the taxpayer's fairness claim, but the Court's analysis suggests some possibilities.

First, the Court articulated a fairness principle unique to statutes of limitations. The Court explained the nature of statutes of repose as being grounded in fairness:

Statutes of limitation, like the equitable doctrine of laches, in their conclusive effects are designed to promote justice by preventing surprises through the revival of claims that have been allowed to slumber until evidence has been lost, memories have faded, and witnesses have disappeared. The theory is that even if one has a just claim it is unjust not to put the adversary on notice to defend within the period of limitation and that the right to be free of stale claims in time comes to prevail over the right to prosecute them.⁴⁵

Then, the Court elevated the fairness attributes of the statute of limitations over those of the taxpayer's recoupment claim based on the system-wide increase in fairness achieved by the statute compared to the individual fairness that might have been achieved by recoupment.⁴⁶ The Court indicated that the recoupment claim would have required an examination of the taxpayer's books and records for many years before the claim was brought.⁴⁷ This was so, the Court explained, because while the one issue of overpaid excise taxes cut in favor of the taxpayer, there may have been other unexamined issues in the earlier years that might cut in the government's favor.⁴⁸ Although both the District Court and the Court of Appeals found that the taxpayer's claim should, in the interest of fairness, be allowed to offset the current tax liability because taxes were mistakenly paid in

⁴³ *Electric Storage Battery III*, 152 F.2d at 524 (quoting *Electric Storage Battery II*, 57 F. Supp. at 735).

⁴⁴ *Electric Storage Battery IV*, 329 U.S. at 301.

⁴⁵ *Id.* (internal quotation marks omitted) (quoting *Order of R.R. Telegraphers v. Ry. Express Agency, Inc.*, 321 U.S. 342, 348–49 (1944)).

⁴⁶ *See id.* at 302 n.3. The Court's decision might also be explained by appeals to efficiency or caseload management. However, the Court employs fairness language in its analysis and I will take it at its word. *Id.*

⁴⁷ *See id.* at 302.

⁴⁸ *See id.* at 302 n.3.

prior years,⁴⁹ the Supreme Court declined to create a rule that would allow recoupment claims of undetermined certainty to prevail over the fairness claims certain to effect the entire tax system.⁵⁰ Accordingly, the individual fairness claim was subordinated to a systemic fairness claim of the statute of limitations.

This analysis suggests that while the Court was sympathetic to the taxpayer's fairness claim, it viewed the claim as incomplete because it did not take into account the scope of inquiry into past years' transactions that would be necessary to judge the claim's fairness.⁵¹ Additionally, the Court indicated, the claim failed to take into account a larger systemic fairness that is inherent in all statute of limitations problems; namely, that administration of claims without finality would be unworkable.⁵² As a result, the Court decided to analyze the taxpayer's claim on the basis of fairness principles including horizontal equity.

Applying horizontal equity, the Court observed that the taxpayer's recoupment claim could work in both directions.⁵³ It would be possible for both taxpayers and the tax collector to circumvent the statute of limitations and make valid claims for a refund.⁵⁴ However, in *McEachern v. Rose*,⁵⁵ the Court ruled against allowing the tax collector to make a claim for reduction of a taxpayer's overpayment refund after the statute of limitations on an earlier unpaid tax had run.⁵⁶ In that case, the Court found that the government could not reduce the taxpayer's otherwise valid refund based on claims for taxes that the government failed to assess years earlier and that were now barred from collection by the statute of limitations.⁵⁷ Accordingly, in order to allow the taxpayer's claim in *Electric Storage Battery*, the Court would

⁴⁹ *Electric Storage Battery IV*, 329 U.S. at 299.

⁵⁰ *See id.* at 302.

⁵¹ The Court stated:

Every assessment of deficiency and each claim for refund would invite a search of the taxpayer's entire tax history for items to recoup. This case provides evidence of the extent to which this would go. When this suit was brought in 1943, the claim pleaded as a recoupment was for taxes collected over twenty years before and for over sixteen years barred by the statute.

Id.

⁵² *See supra* note 42 and accompanying text.

⁵³ *Electric Storage Battery IV*, 329 U.S. at 302 n.3.

⁵⁴ *See id.*

⁵⁵ 302 U.S. 56 (1937).

⁵⁶ *Id.* at 62.

⁵⁷ *Id.* at 60.

have had to reverse *McEachern* or face another serious fairness issue in allowing recoupment by taxpayers, but not by the government.

Horizontal equity is usually stated as a requirement that similarly situated taxpayers should receive similar, if not identical, treatment on issues that are materially indistinguishable. *Electric Storage Battery* varied the traditional understanding of this principal in two ways. First, the government, rather than the taxpayer, raised the claim and, second, the similarly situated parties were the government and the taxpayer rather than the taxpayer and another taxpayer. However, neither the fact that the government raises the claim, nor the substitution of the government for another taxpayer, diminishes or otherwise alters the force of the claim or changes the basic principles on which horizontal equity claims are based.

The commonality between the taxpayer and the government in *Electric Storage Battery* is the application of the statute of limitations. For good and sufficient reasons⁵⁸ the Court, in *McEachern*, found that the government could not employ recoupment to resurrect time-barred claims to offset timely claims for refund made by the taxpayer.⁵⁹ It reasoned that to allow the taxpayer to employ recoupment and to prohibit its use by the government would implicitly violate horizontal equity.⁶⁰ Similarly, the taxpayer in *Electric Storage Battery* failed because the principles of horizontal equity, consistency, regularity, and certainty prevented the taxpayer's use of recoupment where the government was also constrained in that way.⁶¹ Horizontal equity is based upon the application of the law in ways that promote uniformity of treatment among parties. Therefore, reasons for treating one party in a particular way should be just as valid when applied to another party if the facts that are material to such treatment are the same.

⁵⁸ Although the decision in *McEachern* was primarily an exercise in statutory construction, the Court applied a systemic horizontal equity analysis, noting “[t]he similar treatment accorded by the statutes to credit against an overdue tax, and to payment of it; the prohibition of credit of an overpayment of one year against a barred deficiency for another; and the requirement that payment of a barred deficiency shall be refunded, are controlling evidences of the congressional purpose . . .” *McEachern*, 302 U.S. at 62.

⁵⁹ *Id.*

⁶⁰ The Court characterized its holdings in *Stone v. White*, 301 U.S. 532 (1937), and *McEachern* as “[e]quitable considerations not within the reach of the statutes . . .” *McEachern*, 302 U.S. at 62. In my view, the equitable consideration referred to by the Court, though not explicitly explained, is systemic horizontal equity.

⁶¹ “As statutes of limitations are applied in the field of taxation, the taxpayer sometimes gets advantages and at other times the Government gets them.” *Rothenes v. Electric Storage Battery (Electric Storage Battery IV)*, 329 U.S. 296, 302 (1946).

These cases add to our understanding of the application of horizontal equity in two ways. First, the basic tax policy of horizontal equity can now be seen as acting more broadly, encompassing not only similarly situated taxpayers, but also the government and taxpayers if they are similarly situated.⁶² Second, when applying horizontal equity principles the Court finds systemic horizontal claims to be more persuasive than individual fairness claims, which, if upheld would violate horizontal equity principals.⁶³

Application of horizontal equity requires courts to determine which parties are similarly situated and the degree of their similarity. In *Electric Storage Battery*, the Court held that the government, as well as another taxpayer, could be considered a party for the purpose of horizontal equity analysis.⁶⁴ With respect to degree of similarity, in *Badaracco v. Commissioner*,⁶⁵ discussed below, the Court held that a taxpayer who files a fraudulent return and one who fraudulently failed to file a return in the first place are distinct for the purpose of horizontal equity analysis and, thus, may be subject to disparate treatment.⁶⁶

In *Badaracco*, the taxpayers complained of disparate treatment they received when compared to other taxpayers that they identified as similarly situated.⁶⁷ Here, the taxpayers, Ernest Badaracco, Sr. and Ernest Badaracco, Jr., conceded that they filed fraudulent partnership and individual tax returns for calendar years 1965 through 1969.⁶⁸ On August 17, 1971, the taxpayers filed non-fraudulent amended returns for those years and paid additional tax as required by the amended returns.⁶⁹ The amended returns were filed after federal grand juries in New Jersey subpoenaed books and records of the partnership, but before the taxpayers were indicted for filing false and fraudulent returns.⁷⁰ The taxpayers pleaded guilty to the charge with respect to tax year 1967's returns and the remaining counts were

⁶² "Whether or not the statute, §§ 608 and 609 of the Revenue Act of 1928, be taken to compel the conclusion we reach in this case, the court's recognition that both parties to taxation are affected impartially, though perhaps harshly, by policy of repose has application here." *Id.* at 302 n.3.

⁶³ *Id.* at 301.

⁶⁴ *See id.* at 302 n.3.

⁶⁵ 464 U.S. 386 (1984).

⁶⁶ *Id.* at 401.

⁶⁷ *Id.* at 400.

⁶⁸ *Id.* at 389.

⁶⁹ *Id.*

⁷⁰ *Id.*

dismissed.⁷¹ On November 21, 1977, six years and three months after the filing of non-fraudulent amended returns, the Commissioner mailed notices of deficiency to the taxpayers for each of the tax years 1965 through 1969.⁷²

The Commissioner in *Badaracco* argued that § 6501(c)(1) of the Internal Revenue Code (hereinafter “Code”) denied any period of limitations in the case of “a false or fraudulent return with the intent to evade tax.”⁷³ Among other arguments, the taxpayers asserted that it would be “unfair ‘to forever suspend a Sword of Damocles over a taxpayer who at one time may have filed a fraudulent return, but who has subsequently recanted and filed an amended return providing the Government with all the information necessary to properly assess the tax.’”⁷⁴ The taxpayers claimed that reading § 6501(c) literally, as the Commissioner and the courts below had read it, “produces a disparity in treatment between a taxpayer who in the first instance files a fraudulent return and one who fraudulently fails to file any return at all.”⁷⁵ If a taxpayer who has fraudulently failed to file a return for a particular year later files a non-fraudulent return for that tax year, under I.R.C. § 6501(c)(3) that filing will trigger the running of the normal three-year statute of limitations. The *Badaraccos* claimed that they were similar to such a taxpayer and should therefore get similar treatment even though they had filed an earlier fraudulent return.⁷⁶ In practice, this would have meant that the filing of the non-fraudulent second return would have triggered the running of the statute of limitations and the government would have been time-barred from assessing any additional deficiencies against the taxpayers. Under § 6501(c)(1), however, the Court denied that result to the *Badaraccos*.⁷⁷ Despite recognizing that the *Badaraccos* had filed non-fraudulent second returns, the Court declined to treat them as it would treat fraudulent non-filers.

The Court found, however, that Congress intended different limitation results in the two circumstances described by the taxpayers.⁷⁸ It arrived at this conclusion using standard statutory construction techniques and added that if its interpretation were

⁷¹ *Badaracco*, 464 U.S. at 389.

⁷² *Id.*

⁷³ *Id.* at 392 (quoting I.R.C. § 6501(c)(1) (2000)).

⁷⁴ *Id.* at 400 (quoting Brief for Petitioner at 26, *Delect Merch. Corp. v. United States*, 464 U.S. 386 (1984) (No. 82-1509)).

⁷⁵ *Id.* at 400.

⁷⁶ *Id.*

⁷⁷ *Badaracco*, 464 U.S. at 395–96.

⁷⁸ *Id.* at 401.

wrong then Congress should use clearer language.⁷⁹ The Court also took up the fairness claim itself and examined its merits. The Court rejected the taxpayers' fairness claim, stating that "a taxpayer who has filed a fraudulent return with intent to evade tax hardly is in a position to complain of the fairness of a rule that facilitates the Commissioner's collection of the tax due."⁸⁰ Its fairness analysis relied upon estoppel and systemic horizontal fairness. The estoppel notion reflected in the Court's statement that the taxpayers were not in a position to complain of fairness is not unique to tax and is not apposite to this Article. The second fairness analysis, systemic horizontal fairness, is consistent with tax fairness theory and will be discussed below.

The taxpayers in *Badaracco* alleged that their second, non-fraudulent, return provided the Commissioner with all of the information that the Commissioner needed to properly assess the taxpayers liability.⁸¹ If true, then the taxpayers' claim was merely for equal treatment with other taxpayers who had provided the same level of information and for treatment different from those who fraudulently file and never recant.⁸² The Badaraccos appealed to the second principal of tax fairness⁸³ that emerged from *Electric Storage Battery*, similar treatment for taxpayers who are systemically similarly situated, and its corollary, different treatment for differently situated taxpayers.⁸⁴

The Court rejected the Badaraccos' claim by denying that they were similar to other taxpayers who had not first filed fraudulent returns.⁸⁵ The Court articulated significant administrative difficulties that followed when a taxpayer first filed a fraudulent return and then filed an amended non-fraudulent return.⁸⁶ These difficulties included the untrustworthiness of a second return from a fraudulent source (since the new return comes after the taxpayer has already made false statements under penalty of perjury), the likelihood that underlying books and records may also have been falsified, and the administrative timing problems of coordinating a criminal fraud case

⁷⁹ *Id.*

⁸⁰ *Id.* at 400.

⁸¹ *Id.* at 398.

⁸² *Id.* at 400.

⁸³ The first principal being that the government, as well as the taxpayer, could bring a horizontal equity claim. *Rothensies v. Electric Storage Battery (Electric Storage Battery IV)*, 329 U.S. 296, 302 (1946).

⁸⁴ See *id.* at 301-03; see also discussion *supra* text accompanying notes 32-63.

⁸⁵ *Badaracco*, 464 U.S. at 400.

⁸⁶ *Id.* at 398.

with a six year statute of limitations and a civil fraud case with anything less than the same period of limitations.⁸⁷

For the same reasons listed above, the Court also rejected the Badaraccos claim that they were not materially different from taxpayers who fraudulently failed to file any return and later filed a non-fraudulent return.⁸⁸ In such a case, the non-fraudulent return would start the running of the statute whereas the subsequent filing of a non-fraudulent return by the Badaraccos would not.⁸⁹ While the Court conceded that from the taxpayers' point of view the *similarities* between a fraudulent filer and a fraudulent non-filer were significant, the *differences*, discussed above, when viewed from the Commissioner's perspective, were greater.⁹⁰

The Court viewed the similarities offered by the Badaraccos as material.⁹¹ However, the Court viewed the differences offered by the Commissioner as equally material and more persuasive in that they spoke to a fairer system rather than to fairness in a single application.⁹² In a way, the Court was reaffirming the first principal of horizontal equity, articulated in *Electric Storage Battery*, that the government was entitled to be viewed as equal to any other party to a tax fairness claim.⁹³ Here, the government successfully argued that taxpayers who file fraudulent returns present very different

⁸⁷ *Id.* at 398–99.

⁸⁸ *Id.* at 401.

⁸⁹ The Court stated:

The [Badaraccos'] argument centers in § 6501(c)(3), which provides that in a case of failure to file a return, the tax may be assessed 'at any time.' It is settled that this section ceases to apply once a return has been filed for a particular year, regardless of whether that return is filed late and even though the failure to file a timely return in the first instance was due to fraud.

Id.

⁹⁰ "Thus, although there may be some initial superficial plausibility to this argument on the part of petitioners, we conclude that the argument cannot prevail." *Id.*

⁹¹ *Badaracco*, 464 U.S. at 401.

⁹² The Court implied this when it stated that "it seems to us that a taxpayer who has filed a fraudulent return with intent to evade tax hardly is in a position to complain of the fairness of a rule that facilitates the Commissioner's collection of the tax due." *Id.* at 400.

⁹³ In his dissent, Justice Stevens cites *Electric Storage Battery* for the proposition that "a statute of limitation is an almost indispensable element of fairness as well as of practical administration of an income tax policy." *Id.* at 405–06 (Stevens, J., dissenting) (quoting *Rothensies v. Electric Storage Battery (Electric Storage Battery IV)*, 329 U.S. 296, 301 (1946)). As I have argued, the fairness principle of *Electric Storage Battery* is that the government and the taxpayer are equally situated in that they both have an equal stake in the outcome, and that systemic fairness (consistency, regularity, and certainty) is the standard of practical administration referred to by the Court in *Electric Storage Battery*.

administrative problems from taxpayers who do not file at all, even if the reason for non-filing is fraud.⁹⁴ Accordingly, the Badaraccos did not state a claim for similar treatment because they could not establish that they were sufficiently similar to the taxpayers they referenced to warrant similar treatment.⁹⁵

Although both decisions accept the government as a party to a horizontal equity analysis,⁹⁶ *Badaracco* took *Electric Storage Battery* to the next logical step. *Badaracco* pushed the analysis of horizontal equity further by examining the nature of claims of similar situation between parties,⁹⁷ and looking for material similarities and differences. When both are found, the Court weighs the fairness claims. In *Badaracco*, the Court viewed the Commissioner's systemic fairness claim to be more persuasive than the taxpayers' claim of individual unfairness.⁹⁸ The Commissioner's claim had the virtue of consistency (because of the similarities between taxpayers that the Commissioner treated similarly), regularity (because the Commissioner routinely applied the same rule to all taxpayers), and certainty (because it was a bright line test from which there was no deviation).⁹⁹ Accordingly, although unrelated to ability to pay, the Court's analysis was nonetheless horizontal because it looked for material similarities and differences in grouping taxpayers. The point of similarity was systemic rather than substantive because it was about application within the system, not about the Code's content.

In these two cases, the Court adopted horizontal equity principles in applying systemic tax rules, even though it did not articulate an explicit horizontal equity standard. This is the start of what this

⁹⁴ *Id.* at 398–99 (majority opinion).

⁹⁵ *Id.* at 401.

⁹⁶ In *Electric Storage Battery*, the Court stated that “[a]s statutes of limitation are applied in the field of taxation, the taxpayer sometimes gets advantages and at other times the Government gets them. Both hardships to the taxpayers and losses to the revenues may be pointed out.” 329 U.S. at 302. In *Badaracco*, the Court is not so explicit in stating its goal for the equal application of tax fairness to the taxpayer and government, but the Court's holding implicitly makes the same point. 464 U.S. at 386.

⁹⁷ *Badaracco*, 464 U.S. at 398–401.

⁹⁸ Trustworthiness and reconciliation of civil and criminal fraud administration were cited by the Court in favor of the government. *Id.* at 398–99. Both of those reasons are within what I have called systemic horizontal equity because they concern tax administration regularity. These reasons concern the efficient process of evaluating the tens of thousands of tax returns that the government must examine. If the Court agreed with the taxpayers' claim that their similarity to other taxpayers was a higher value than the systemic horizontal equity value of regularity, then the efficient and fair treatment of all taxpayers would have been diminished.

⁹⁹ *See id.* at 398–99.

Article calls “systemic horizontal equity.” It is systemic rather than substantive because it does not employ substantive horizontal equity concerns such as ability to pay, wealth, or consumption. Instead, the Court applies systemic horizontal equity principles of consistency, regularity, and certainty. The distinction is important because systemic horizontal equity is content-neutral whereas substantive horizontal equity is content-based.

B. Development of Systemic Horizontal Equity Beyond Statute of Limitations Cases

Although the Supreme Court may not always use the word fairness in addressing tax questions, fundamental fairness principles are sometimes implicitly used in analyzing the statutes. Moreover, taxpayers in some cases have claimed that the treatment they received from the Service was unfair. Accordingly, even though the Court does not explicitly use fairness in its analysis, it may do so by implication in ruling on taxpayers’ claims of unfair treatment.

The Commissioner publishes rulings and takes litigation positions consistent with his or her understanding of the law at the time. As this understanding evolves, the Commissioner may change positions previously announced. Taxpayers have argued that these changes in position can be unfair to taxpayers in one of two ways. First, taxpayers have argued that unfairness might result if a taxpayer relies in good faith upon a position taken by the Commissioner and structures a transaction or takes other measures consistent with the Commissioner’s position only to find a later change in position, without a change in the law. Second, an unfairness claim has been asserted when one taxpayer received favorable tax treatment under a ruling of the Commissioner and a second identically situated taxpayer received a different and less favorable treatment by the Commissioner after a change in position, even when there has been no change in the law. The Supreme Court recognizes neither of these circumstances as unfair to the taxpayer.

In *Dickman v. Commissioner*,¹⁰⁰ the taxpayers made substantial interest-free loans to their son.¹⁰¹ The issue before the Court was whether the foregone interest was a gift within the meaning of § 2501(a)(1) of the Code, subjecting the taxpayer to gift tax liability.¹⁰² After determining that the foregone interest was a gift under

¹⁰⁰ 465 U.S. 330 (1984).

¹⁰¹ *Id.* at 331–32.

¹⁰² *See id.* at 331.

the Code, the Court turned to the taxpayers' claim that their reliance upon previous positions announced by the Commissioner insulated them against liability under the Commissioner's new interpretation of the Code.¹⁰³ The Court rejected the claim, specifically noting that the Commissioner may "change an earlier interpretation of the law, even if such a change is made retroactive in effect."¹⁰⁴ Moreover, the Court indicated, "[t]his rule applies even though a taxpayer may have relied to his detriment upon the Commissioner's prior position."¹⁰⁵

Although the taxpayers' claim of unfairness was expressly based upon detrimental reliance, it was also implicitly based upon a comparison of their treatment by the Commissioner against that afforded to taxpayers who reported identically structured transactions prior to the Commissioner's change of view as to the correct interpretation of the law. By denying the taxpayers' unfairness claim, the Court denied a systemic horizontal equity claim, as well. Thus, the case stands for the proposition that, while the systemic horizontal equity norms of consistency, regularity, and certainty may help in resolving tax disputes, they must defer to the superior administrative norm of continuing statutory interpretation and the necessary disparate treatment that may ensue.

In *Dickman*, the Court held that a horizontal tax equity claim that compares taxpayers in identical circumstances who were afforded disparate treatment due to shifting interpretations of the law will not succeed.¹⁰⁶ If the rule were otherwise, of course, the Commissioner could never change his or her mind and seek enforcement of a change of opinion about the law. The Court rightly seems to have viewed the taxpayers' fairness claim as seeking to elevate horizontal equity over the Commissioner's good faith reinterpretations of the Code, which due to the passage of time, works different results on similarly situated taxpayers.

Interestingly, this principle works in only one direction. Suppose that the Court had found that the taxpayers' interpretation of

¹⁰³ See *id.* at 342–43 ("Finally, petitioners urge that the Commissioner should not be allowed to assert the gift taxability of interest-free demand loans because such a position represents a departure from prior Internal Revenue Service practice. This contention rests on the fact that, prior to 1966, the Commissioner had not construed the gift tax statutes and regulations to authorize the levying of a gift tax on the value of the use of money or property. From this they argue that it is manifestly unfair to permit the Commissioner to impose the gift tax on the transactions challenged here." (citing *Crown v. Comm'r*, 585 F.2d 234, 241 (7th Cir. 1978); *Johnson v. United States*, 254 F. Supp. 73 (N.D. Tex. 1966))).

¹⁰⁴ *Id.* at 343.

¹⁰⁵ *Id.* (citing *Dixon v. United States*, 381 U.S. 68, 73 (1965)).

¹⁰⁶ See *supra* notes 103–05 and accompanying text.

§ 2501(a)(1) correct. Further, suppose that the Commissioner's earlier interpretation had been the opposite, so that earlier the Commissioner had thought the foregone interest was a gift but then reversed his opinion and viewed it as outside the scope of § 2501(a)(1). Now taxpayers who were adversely affected by the prior ruling would be able to seek review of their returns and the Commissioner would accede to his new position. In this way, horizontal equity would be available when the Commissioner changes his mind in ways that favor the taxpayer.¹⁰⁷ In other words, the Commissioner would extend the latter treatment, now viewed to be statutorily correct, to earlier taxpayers, identically situated, who had previously not received the same treatment as taxpayers who were later in time.

In *Automobile Club of Michigan v. Commissioner*,¹⁰⁸ the taxpayer received favorable rulings in 1934 and 1938, which exempted the taxpayer from federal income taxes.¹⁰⁹ Those rulings were retroactively revoked in 1945 and the Commissioner sought tax liability for tax years 1943 and 1944.¹¹⁰ The Court found that the "Commissioner's earlier rulings were grounded upon an erroneous interpretation of the term 'club' in § 101(9) and thus were based upon a mistake of law."¹¹¹ The Court continued by noting the specific grant of authority in the Commissioner to apply any "ruling, regulation, or Treasury Decision" retroactively.¹¹²

Although the taxpayer's position in *Automobile Club* was similar to that advanced by the taxpayer in *Dickman*, it was somewhat stronger because, in *Automobile Club*, the taxpayer who received the favorable treatment under prior Commissioners' interpretations of the law was the same taxpayer who was now bringing the claim.¹¹³ Nevertheless, the Court rejected the taxpayer's claim for the same reasons given in *Dickman*.¹¹⁴ From these two cases, it is clear that the Court will not

¹⁰⁷ This would not be true, however, for taxpayers who are time-barred by the statute of limitations.

¹⁰⁸ 353 U.S. 180 (1957).

¹⁰⁹ *See id.* at 181.

¹¹⁰ *See id.*

¹¹¹ *Id.* at 183.

¹¹² *Id.* at 184 ("The Secretary, or the Commissioner with the approval of the Secretary, may prescribe the extent, if any, to which any ruling, regulation, or Treasury Decision, relating to the internal revenue laws, shall be applied without retroactive effect.") (quoting I.R.C. § 3791(b) (1939)).

¹¹³ "The Commissioner had determined in 1934 that the petitioner was a 'club' entitled to exemption under provisions of the internal revenue laws The Commissioner revoked these rulings in 1945 . . ." *Id.* at 182.

¹¹⁴ "[I]t is well established that the Commissioner may change an earlier interpretation of the law, even if such a change is made retroactive in effect." *Dickman v.*

consider disparate taxpayer treatment, based upon changed ruling positions, as a violation of the principles of systemic horizontal equity.

One may instead analogize administrative changes of position to legislative modification. Taxpayers divided by legislation that affects their tax liabilities may only be viewed as similar if the events at issue arose prior to or after the relevant legislation.¹¹⁵ Similarly, while the taxpayers in *Automobile Club* and *Dickman* drew comparisons with other taxpayers positioned on the other side of the administrative change, the Court viewed taxpayers as falling into similar groups only if they fell on the same side of the change.¹¹⁶ Thus, systemic horizontal equity allows for administrative change in the same way it allows for legislative change. Taxpayers may make systemic horizontal equity claims, but the group within which they may find similarities must account for the change.¹¹⁷

Comm'r, 465 U.S. 330, 343 (1984). “[I]t is clear from the language of the section and its legislative history that Congress thereby confirmed the authority of the Commissioner to correct any ruling, regulation or treasury decision retroactively, but empowered him, in his discretion, to limit retroactive application to the extent necessary to avoid inequitable results.” *Automobile Club of Mich.*, 353 U.S. at 184.

¹¹⁵ Most legislation is prospective in that the statute applies to “conduct, events, and circumstances which occur after its enactment.” 2 NORMAN J. SINGER, SUTHERLAND STATUTORY CONSTRUCTION § 41.01 (5th ed. Clark Boardman Callaghan 1993). Tax legislation is more complex in that “[t]ax legislation may be retroactive if the legislature clearly so intends.” *Id.* § 41.10.

¹¹⁶ “We thus find no basis for disagreeing with the conclusion, reached by both the Tax Court and the Court of Appeals, that the Commissioner, having dealt with petitioner upon the same basis as other automobile clubs, did not abuse his discretion.” *Automobile Club of Mich.*, 353 U.S. at 186.

¹¹⁷ No discussion of horizontal equity in the administration of the Internal Revenue Code would be complete without some mention of *IBM v. United States*, 343 F.2d 914 (Ct. Cl. 1965). In that case, the Court of Claims allowed the taxpayer to prevail on a horizontal equity claim in which IBM sought a favorable private letter ruling on a matter materially identical to one on which its only competitor had obtained a favorable letter ruling. The Claims Court allowed IBM the same treatment afforded its competitor, even though the Commissioner had changed his mind on the law in the interim. Courts have subsequently limited the application of *IBM* to cases in which the taxpayers are the only two competitors in the field, both have sought guidance that only one has received, and where that guidance was initially favorable, but subsequently shown to be incorrect. *See, e.g., Peerless Corp. v. United States*, 185 F.3d 922, 929 (8th Cir. 1999). It is, of course, not clear how the Supreme Court would have decided *IBM*, given its view that systemic horizontal equity does not require that taxpayers receive identical treatment when separated by a change in the Commissioner’s opinion about the law. Therefore, it seems likely the Supreme Court would not have ruled as the Claims Court did. However, because this Article’s scope is confined to Supreme Court jurisprudence of tax fairness, I will not address the issues raised in *IBM*.

IV. THE ROLE OF FAIRNESS IN STATUTORY CONSTRUCTION

When interpreting individual Code provisions, the Supreme Court has embraced a notion of fairness that reflects horizontal equity. The Court has construed statutory provisions in ways that result in “consistency, regularity, and certainty.”¹¹⁸ In other words, the Court follows the principle of systemic horizontal equity. The Court employed substantive horizontal equity where the distinctions created by Congress were meant to further horizontal equity based upon ability to pay, wealth, or consumption.

*United States v. Correll*¹¹⁹ concerned a taxpayer who, in the pursuit of his wholesale grocery business, left home early in the morning, ate breakfast and lunch on the road, and returned home in time for dinner.¹²⁰ He sought to deduct the cost of his breakfast and lunch as business expenses under § 162(a)(2) of the Code. Section 162(a)(2) provides that traveling expenses, including meals, may be deducted if they are incurred “while away from home in the pursuit of a trade or business.”¹²¹ The Commissioner interpreted that provision to exclude expenses incurred on travel that required neither sleep nor rest.¹²² The Court analyzed § 162(a)(2) by weighing the fairness of the Commissioner’s interpretation against that of the taxpayer.

The analysis begins not only with § 162, which authorizes deductibility of business expenses, but also with § 262,¹²³ which denies deductibility of personal expenses. It begins here because of an apparent horizontal equity problem posed by the deductibility of meal expenses to one class of taxpayers as opposed to the non-deductibility of the same expenses by other classes of taxpayers. In other words, taxpayers who do not travel for business reasons, and who have no other business connection to their meals, may not deduct the cost of their meals, whereas taxpayers who can show a business connection to their meals may be able to deduct their expenses. This seeming inconsistency is the result of the intersection of two tax principles. One principal, expressed in § 262, prohibits the deductibility of personal expenses and the other, expressed in § 162, allows the deduction of business expenses including those that would otherwise be viewed as personal if imbued with sufficient business content.¹²⁴

¹¹⁸ *Ivan Allen Co. v. United States*, 422 U.S. 617, 641 (1975).

¹¹⁹ 389 U.S. 299 (1967).

¹²⁰ *See id.* at 303.

¹²¹ I.R.C. § 162(a)(2) (2000).

¹²² *Correll*, 389 U.S. at 302.

¹²³ I.R.C. § 262 (2000).

¹²⁴ *Correll*, 389 U.S. at 300.

The Court said that the fact that the Code specifically allows the cost of meals to be deducted by some taxpayers while denying deductions to other taxpayers who spend money for meals can be viewed as a “windfall” for business travelers.¹²⁵

Congress artlessly divided meals into deductible and non-deductible based upon whether the meals were incurred while “away from home.”¹²⁶ The Court was left with the job of fashioning a rule that fairly grouped taxpayers into each category, deductible and nondeductible, based upon the thin statutory distinction of being incurred away from home in the pursuit of business. This is a horizontal equity problem because the Court must find a test based on characteristics that link taxpayers with similarly strong business reasons for deducting the meal expense and exclude taxpayers with similarly weak business reasons for incurring the meal expense. This is a substantive horizontal equity analysis because the distinction concerns questions about differing consumption rather than the systemic horizontal equity questions of consistency, regularity, and certainty.

The chief reason for deducting meal expenses associated with business travel is the duplication of expenses incurred by such a traveler. Normally, a person can plan his or her business day around the personal necessity of meals; breakfast at home, lunch either prepared at home or eaten at restaurants by choice; and dinner at home. The businessperson who is traveling away from home generally loses the option of home-prepared meals. The business traveler is therefore viewed as incurring the expenses of meal preparation twice, once at home in the form of food preparation facilities in the taxpayer’s residence and again when the businessperson must pay others to prepare meals he or she could otherwise prepare at home.¹²⁷

¹²⁵ “[T]he taxpayer who incurs substantial hotel and restaurant expenses because of the special demands of business travel receives something of a windfall, for at least part of what he spends on meals represents a personal living expense that other taxpayers must bear without receiving any deduction at all.” *Id.* at 301–02.

¹²⁶ “There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business, including . . . traveling expenses (including amounts expended for meals and lodging other than amounts which are lavish or extravagant under the circumstances) while away from home in the pursuit of a trade or business . . .” I.R.C. § 162(a)(2) (2000).

¹²⁷ “Because § 262 makes ‘personal, living, or family expenses’ nondeductible . . . the taxpayer whose business requires no travel cannot ordinarily deduct the cost of the lunch he eats away from home. But the taxpayer who can bring himself within the reach of § 162(a)(2) may deduct what he spends on his noontime meal although it costs him no more, and relates no more closely to his business, than does the lunch consumed by his less mobile counterpart.” *Correll*, 389 U.S. at 302 n.7.

The Court acknowledged that it should defer to the interpretation of the statute given by the Commissioner but also struggled to find principled methods for grouping business travelers that fairly treated similarly situated taxpayers alike and which furthered the distinctions based upon personal consumption and business expense.¹²⁸ In other words, the Court agreed that similarly situated taxpayers should be treated alike and then sought to identify those groups consistent with the demands of §§ 162 and 262.

The taxpayer in *Correll* argued in favor of a rule that turned on either the distance from home or the number of hours spent away from home.¹²⁹ The Commissioner rejected both rules and argued for one that denied deductibility to any taxpayer who was not required to sleep or rest while away from home.¹³⁰ None of these rules was required by the statute, yet one consistent rule was desired.

The Court viewed application of both standards advanced by the taxpayer as inconsistent with the treatment of other taxpayers who traveled miles that were greater or fewer than any number that the Court might select.¹³¹ Understanding that any rule it fashioned would be subject to the criticism that it was in some measure arbitrary,¹³² the Court therefore rejected the taxpayer's claim of similarity or difference between taxpayers otherwise similarly situated based upon distance or time. In so doing, it acknowledged that the factors advanced by the taxpayer were reasonable ways to group similarly situated taxpayers. Several amicus briefs supported the taxpayer's proposals.¹³³ The Court considered the distance factor and the time

¹²⁸ *Id.* at 304–05. The Court stated that “[o]rdinarily, at least, only the taxpayer who finds it necessary to stop for sleep or rest incurs significantly higher living expenses as a direct result of his business travel, and Congress might well have thought that only taxpayers in that category should be permitted to deduct their living expenses while on the road.” *Id.* at 304–05. In other words, only the taxpayer who incurs extra consumption gets to deduct expenses that would not otherwise be deductible because they are personal (e.g., meals).

¹²⁹ *Id.* at 303–04.

¹³⁰ *Id.* at 302.

¹³¹ The Court stated:

Any rule in this area must make some rather arbitrary distinctions, but at least the sleep or rest rule avoids the obvious inequity of permitting the New Yorker who makes a quick trip to Washington and back, missing neither his breakfast nor his dinner at home, to deduct the cost of his lunch merely because he covers more miles than the salesman who travels locally and must finance all his meals without the help of the Federal Treasury.

Id. at 303–04.

¹³² *Correll*, 389 U.S. at 303.

¹³³ *Id.* at 304 n.14.

factor the taxpayer suggested, however, and found that both would exclude taxpayers from the group entitled to deduct meal expenses occupied by Mr. Correll without addressing the underlying reason for the distinction—duplication of expenses.¹³⁴ In support of the “sleep or rest”¹³⁵ rule the Court stated:

By so interpreting the statutory phrase, the Commissioner has achieved not only ease and certainty of application but also substantial fairness, for the sleep or rest rule places all one-day travelers on a similar tax footing, rather than discriminating against intracity travelers and commuters, who of course cannot deduct the cost of the meals they eat on the road.¹³⁶

The Court viewed distance traveled and time spent traveling as inapposite to the reason for distinguishing between similarly situated taxpayers in the meal context—closer ties to the business generated extra expense, and thus extra consumption. The Court explained its preference for the Commissioner’s view by reasoning that, “only the taxpayer who finds it necessary to stop for sleep or rest incurs significantly higher living expenses as a direct result of his business travel”¹³⁷

This finding fits into one of the principled reasons for distinguishing between taxpayers who are otherwise similarly situated. If taxpayers incur greater expense than they otherwise would, and they do so for business reasons, then the statute may be applied to address the expense incurred for those reasons. Accordingly, the Court in *Correll* adopted a more equitable interpretation by grouping taxpayers according to duplicative meal expenses. The Court’s reasoning incorporated a substantive horizontal equity analysis because it concerned the taxpayer’s ability to pay tax on income earned from the taxpayer’s trade or business. If duplicative expenses that, although personal in nature, were incurred for a business purpose were not deductible, then the taxpayer would be disadvantaged with respect to others with the same income who did not incur the duplicative expense. The Court’s interpretation recognized that distinction.

In *Correll*, the Court looked for a way to group taxpayers that furthered the underlying tax theory that supported the benefit that

¹³⁴ *Id.* at 305 n.18.

¹³⁵ In order to meet the statutory requirement that the taxpayer is away from home in order to deduct the cost of meals incurred as part of business travel, the Commissioner’s position is that the taxpayer must “sleep or rest” while on the business trip. *Id.* at 299.

¹³⁶ *Id.* at 303.

¹³⁷ *Id.* at 304–05.

taxpayers sought.¹³⁸ In that case, the underlying tax theory concerned a redundant expense associated with meals incurred for business reasons.¹³⁹ The distinctions of time and distance offered by the taxpayer were viewed as being further from those reasons than the distinction offered by the Commissioner.¹⁴⁰ Regardless of whether one agrees with the Court's conclusion, the interesting aspect of the decision is the effort made to identify the criteria that are most congruent with the underlying reason for the distinction. The relevance of the offered criteria is measured by the Court against the reason for the statute, hardly a surprising proposition.¹⁴¹ Yet all of the criteria offered would advance the goal of distinguishing between taxpayers who were more likely to have incurred extra expense due to travel and those who were not. The Commissioner's criteria had the virtues of both a bright line test and flexibility.

A person traveling by plane might cover more ground than one traveling by car in the same time frame. If that time were just a few hours, it is difficult to see how meal expenses greater than normal would have been made necessary even though distance traveled might in other contexts capture the statutory notion of a duplicative expense. Distance traveled, therefore, seems less relevant than time traveled. However, if time traveled is to be the criteria, how much time is necessary to trigger the deduction? Would a meal expense incurred on an eight hour and one minute trip be deductible while meal expense incurred on an eight hour trip would not? The arbitrariness of this time distinction would appear to make this option less attractive than the rule advanced by the Commissioner in *Correll*, which provided tighter congruence with the statute's rationale. If the taxpayer sleeps away from home, he or she is necessarily separated from the food preparation facilities, which have already been paid

¹³⁸ "Alternatives to the Commissioner's sleep or rest rule are of course available. Improvements might be imagined. But we do not sit as a committee of revision to perfect the administration of the tax laws." *Correll*, 389 U.S. at 306-07.

¹³⁹ "The taxpayer must ordinarily 'maintain a home for his family at his own expense even when he is absent on business,' and if he is required to stop for sleep or rest, 'continuing costs incurred at a permanent place of abode are duplicated.'" *Id.* at 306 n.18 (citations omitted).

¹⁴⁰ "And the Commissioner's rule surely makes more sense than one which would allow the respondent . . . to deduct the cost of his breakfast and lunch simply because he spends a greater percentage of his time at the wheel than the commuter who eats breakfast on his way to work and lunch a block from his office." *Id.* at 304.

¹⁴¹ "The language of the statute— 'meals and lodging . . . away from home'—is obviously not self-defining. And to the extent that the words chosen by Congress cut in either direction, they tend to support rather than defeat the Commissioner's position" *Id.*

for, and must seek local food preparation at a duplicative cost. This means, of course, that Taxpayer *A*, who travels one thousand miles in her business day but never sleeps away from home, will get no deduction, but Taxpayer *B*, who travels fewer miles but does sleep away from home, will get the deduction. While not a perfect fit, this distinction is closer to that contemplated by Congress and more material to the question of categorization of the taxpayers into groups for purposes of horizontal equity.

Correll appears to be the only case in which the Court employed a content-based substantive horizontal equity analysis. However, the Court in *Correll* also applied a systemic horizontal equity analysis when it required that §§ 162 and 262 be reconciled for both consistency and certainty.¹⁴² This reconciliation is well within the systemic horizontal equity norm of consistency. Accordingly, the use of one type of horizontal equity analysis does not preclude the other. It appears that the Court believes that Congress intends to incorporate both horizontal equity principles in the legislation it passes.¹⁴³ If that were true, the Court would be justified in applying those same principles in the interpretative process. However, substantive questions concerning income, wealth, or consumption levels are seldom contemplated by the Court, which usually confines its inquiry to questions of consistency, regularity, and certainty.

In applying a substantive horizontal equity analysis, the Court in *Correll* classified taxpayers into similar groups by looking for distinctions that most closely tracked the statute's underlying principles.¹⁴⁴ The Court rejected distinctions that excluded taxpayers who logically

¹⁴² “[T]he Commissioner has achieved not only ease and certainty of application but also substantial fairness” *Id.* at 303. Accordingly, the systemic principle of certainty and the substantive principle of ability to pay are reconciled in this decision.

¹⁴³ “Not surprisingly, therefore, Congress did not extend the special benefits of § 162(a)(2) to every conceivable situation involving business travel.” *Id.* at 302.

¹⁴⁴ The Court stated:

Any rule in this area must make some rather arbitrary distinctions, but at least the sleep or rest rule avoids the obvious inequity of permitting the New Yorker who makes a quick trip to Washington and back, missing neither his breakfast nor his dinner at home, to deduct the cost of his lunch merely because he covers more miles than the salesman who travels locally and must finance all his meals without the help of the Federal Treasury. And the Commissioner's rule surely makes more sense than one which would allow the respondent in this case to deduct the cost of his breakfast and lunch simply because he spends a greater percentage of his time at the wheel than the commuter who eats breakfast on his way to work and lunch a block from his office.

Correll, 389 U.S. at 303–04.

should have been within the beneficial category.¹⁴⁵ Accordingly, the classifications offered by the taxpayers that were over- or under-inclusive were relevant, but not as congruent as the one offered by the Commissioner.¹⁴⁶ Materiality, therefore, in the context of horizontal equity, requires that the criterion used to identify similarly situated taxpayers be one that most closely advances the underlying reason for the statute.¹⁴⁷

The lessons of *Correll* are two. First, the Court used substantive horizontal equity theory in its construction of one Code provision because it grouped taxpayers according to similarities based on levels of consumption and ability to pay the tax on their business earnings.¹⁴⁸ In other words, the Court indirectly tracked ability to pay tax with extra consumption incurred for business reasons. This can be illustrated by imagining two taxpayers, *A* and *B*, with identical taxable incomes of \$40,000. Further imagine that Taxpayer *B* incurs \$1,000 in meal and lodging expenses, that duplicate his personal expenses, but which are incurred for business reasons, whereas Taxpayer *A* does not. If Taxpayer *B* cannot further reduce his taxable income by those expenses, then his taxable income will be artificially high, meaning that although his taxable income would be \$40,000 it would not reflect one of the expenses incurred in earning that income. Additionally, he will have fewer after-tax dollars to pay the tax because of the \$1,000 he spent on food and lodging, which are therefore no longer available to pay the tax. Second, when faced with competing horizontal equity claims, one factor the Court considered was consistency with other sections of the Code.¹⁴⁹ In *Correll*, that meant consistency between §§ 162 and 262 of the Code.¹⁵⁰ This ver-

¹⁴⁵ *Id.*

¹⁴⁶ *Id.*

¹⁴⁷ See *supra* text accompanying note 141.

¹⁴⁸ The Court stated:

Rather than requiring 'every meal-purchasing taxpayer to take pot luck in the courts,' the Commissioner has consistently construed travel 'away from home' to exclude all trips requiring neither sleep nor rest, regardless of how many cities a given trip may have touched, how many miles it may have covered, or how many hours it may have consumed. By so interpreting the statutory phrase, the Commissioner has achieved not only ease and certainty of application but also substantial fairness, for the sleep or rest rule places all one-day travelers on a similar tax footing, rather than discriminating against intracity travelers and commuters, who of course cannot deduct the cost of the meals they eat on the road [under § 262].

Correll, 389 U.S. at 302–03 (citations omitted).

¹⁴⁹ *Id.*

¹⁵⁰ *Id.*

sion of horizontal equity falls more neatly within systemic horizontal equity analysis. *Correll*, therefore, is an example of the Court using both substantive and systemic horizontal equity analyses in interpreting the Code. The next case in this section, *Commissioner v. First Security Bank of Utah, N.A.*,¹⁵¹ focuses on the Court's use of systemic horizontal equity analysis.

In *First Security Bank*, the Court applied fairness principles to determine whether § 482 of the Code authorized the Commissioner to allocate income from an insurance company to a bank where both were owned by the same holding company and the bank was prohibited by law from earning the type of income sought to be allocated. In *First Security Bank*, as it did in *Correll* and *Commissioner v. Groetzinger*,¹⁵² the Court used fairness principles to identify similarly situated taxpayers and any reasons for distinguishing among them.¹⁵³ First, the Court looked for consistency with other federal laws, in this case other federal banking laws.¹⁵⁴ This reinforced the view that tax fairness requires equal treatment among taxpayers with equal tax attributes. The Court also injected a more formal notion of fairness following the form required by other federal laws.

Fairness, as used by the Court in *First Security Bank*, is a systemic claim similar to the systemic claim in *Correll*. In both cases, the Court searched for ways to increase consistency across the taxing system. In *Correll*, the Court found a way to consistently apply §§ 162 and 262 so as to maintain the integrity of both. In *First Security Bank*, the Court applied the tax statute in a way that resulted in increased consistency with other, non-tax legislation.

In *Commissioner v. Groetzinger*,¹⁵⁵ the Court again interpreted § 162, this time in the context of its requirement that a taxpayer be engaged in a "trade or business" before any amounts expended by the taxpayer may be deducted for purposes of the alternative minimum tax as it existed at that time. In 1978, Groetzinger devoted sixty to eighty hours per week to gambling.¹⁵⁶ Unfortunately, his winnings

¹⁵¹ 405 U.S. 394 (1972).

¹⁵² 480 U.S. 23 (1987); see *infra* text accompanying notes 155–158.

¹⁵³ "As stated in the Treasury Regulations, the 'purpose of section 482 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer . . .'" *First Security Bank*, 405 U.S. at 407.

¹⁵⁴ "We think that fairness requires the tax to fall on the party that actually receives the premiums rather than on the party that cannot." *Id.* at 405.

¹⁵⁵ 480 U.S. 23 (1987).

¹⁵⁶ See Andrew M. Curtis, *Commissioner v. Groetzinger—Supreme Court Holds That the "Goods or Services" Test Is Not a Prerequisite to "Trade or Business" Status*, 22 WAKE FOREST L. REV. 221, 222 (1987).

of \$70,000 were more than offset by losses of \$72,032. In order to get the full benefit of his losses for alternative minimum tax purposes, the taxpayer had to have incurred the losses in his trade or business as that term was used in § 162(a). In analyzing the statute, the Court considered its own prior decisions and also considered the fairness of allowing the taxpayer's full-time gambling activity to fall within the § 162(a) definition of trade or business.

If a taxpayer, as *Groetzinger* is stipulated to have done in 1978, devotes his full-time activity to gambling, and it is his intended livelihood source, it would seem that basic concepts of fairness (if there be much of that in the income tax law) demand that his activity be regarded as a trade or business just as any other readily accepted activity, such as being a retail store proprietor or, to come closer categorically, as being a casino operator or as being an active trader on the exchanges.¹⁵⁷

In interpreting § 162, the Court embraced a fairness analysis that identifies similarly situated taxpayers and asks whether there is a systemic or substantive principled reason for distinguishing among them. In *Groetzinger*, there was no other statute demanding consistent treatment as there was in *Correll*.¹⁵⁸ There was also no claim by the Commissioner that the taxpayer's horizontal equity claim would result in a substantially more difficult administrative burden.

The Commissioner's claim was not founded on fairness in general or on any modern notion of vertical or horizontal equity. Rather, the Commissioner argued that the statutory language at issue, the definition of "trade or business," was resolved by *Deputy v. DuPont*,¹⁵⁹ in which Justice Frankfurter opined that one must offer goods or services to be in a trade or business. The *Groetzinger* Court specifically rejected this definition as underinclusive.¹⁶⁰ The Court thought the taxpayer would be within the *DuPont* test if one viewed it under a form of systemic horizontal equity analysis because "it takes two to gamble."¹⁶¹ That analysis is horizontal in that it compares two simi-

¹⁵⁷ *Groetzinger*, 480 U.S. at 33.

¹⁵⁸ *Correll*, 389 U.S. at 300 ("Because the respondent's daily trips required neither sleep nor rest, the Commissioner disallowed the deductions, ruling that the cost of the respondent's meals was a 'personal, living' expense under § 262 rather than a travel expense under § 162(a)(2).").

¹⁵⁹ 308 U.S. 488 (1940).

¹⁶⁰ "But does it necessarily follow that one who does not satisfy the Frankfurter adumbration is not in a trade or business? . . . In any event, while the offering of goods and services usually would qualify the activity as a trade or business, this factor, it seems to us, is not an absolute prerequisite." *Groetzinger*, 480 U.S. at 33-34.

¹⁶¹ *Id.* at 33. The phrase "it takes two to gamble" actually comes from the taxpayer's brief. Brief for the Respondent at 3, *Groetzinger*, 480 U.S. 23 (No. 85-1226),

larly situated taxpayers—those on opposite sides of a single gambling transaction. It does not, however, concern a comparison between the two taxpayers on the grounds of their ability to pay, their wealth, or their consumption. Instead, it concerns the consistency of their treatment under the Code.

The Court found no principled reason to define one side of a business transaction to be in a trade or business while not defining the other as such, but this alleged imbalance is common. When I buy milk from the grocer it does not mean that I am in the grocery business. To allow the Court to view both sides as similarly situated, there must be something more to the analysis than simply being on opposite sides of a single transaction. In *Groetzing*, the additional element is the time spent by the taxpayer in the pursuit of gambling.¹⁶² Thus, the transaction was common between the parties and so was the time spent in the common activity. Both sides devoted all of their professional time to the same activity. This suggests that in measuring consistency for purposes of horizontal equity, magnitude is not measured on a separate axis. It is instead a further component of the primary question of similarity.

Although unstated, the Court implied that taxpayers who occasionally gamble are not within the class of taxpayers whose business is gambling under § 161.¹⁶³ The difference is the magnitude of the gambling. In order to be within the class of taxpayers who may make a claim for similar treatment on the basis of their occupying opposite sides of the same transaction, as in the milk illustration above, the amount of time spent in the claimed pursuit will distinguish between those who prevail on the claim and those who will not. Magnitude is therefore not a separate inquiry from classification under horizontal equity; it is instead a component of horizontal equity classification.

Correll, *Groetzing*, and *First Security Bank*, along with the dissent in *Ivan Allen Co. v. United States*,¹⁶⁴ establish three principles for ana-

1985 WL 669433. However, the Court cites it with approval and suggests that even if the *DuPont* test were the only test to be applied, the Court would still rule for the taxpayer. *Groetzing*, 480 U.S. at 33 & n.12 (“It takes a buyer to make a seller and it takes an opposing gambler to make a bet.”) (citations omitted).

¹⁶² *Groetzing*, 480 U.S. at 36. The Court noted that “[c]onstant and large-scale effort on [Groetzing’s] part was made. . . . This was not a hobby or a passing fancy or an occasional bet for amusement.” *Id.*

¹⁶³ “[W]e conclude that if one’s gambling activity is pursued full time, in good faith, and with regularity, to the production of income for a livelihood, and is not a mere a hobby, it is a trade or business within the meaning of the statutes with which we are here concerned.” *Id.* at 35.

¹⁶⁴ 422 U.S. 617, 641–42 (1975) (Powell, J., dissenting) (“Whatever may be said for the Court’s view of the ‘unreality’ of adhering to the principles of sound accounting

lyzing the fairness of statutory construction. First, statutes will be interpreted according to the horizontal equity principle that similarly situated taxpayers should be treated alike. Second, horizontal equity itself has two subsets that I have termed systemic and substantive horizontal equity. The factors used by the Court in the systemic horizontal equity analysis are consistency with other federal law (both tax and non-tax), regularity, and certainty. Congruity with the underlying reasons for the statute, where the underlying reasons include consumption or ability to pay, refers to the substantive horizontal equity analysis. Third, the Court will view magnitude of similarity as a component of defining the class itself rather than as a separate concern.

V. TAX FAIRNESS AS A COMPONENT OF CONSTITUTIONAL EQUAL PROTECTION

In 1989 and 1992, the Supreme Court handed down two opinions that set forth the Court's view of tax fairness in the context of the Equal Protection Clause of the United States Constitution. In the first case, *Allegheny Pittsburgh Coal Co. v. County Commission*,¹⁶⁵ the Court considered a West Virginia county tax assessor's practice that "valued . . . real property on the basis of its recent purchase price, but made only minor modifications in the assessments of land which had not been recently sold."¹⁶⁶ The Court held that the resulting gross disparities in assessed value of otherwise comparable property violated the Equal Protection Clause of the Constitution.¹⁶⁷

In the second case, *Nordlinger v. Hahn*,¹⁶⁸ the Court found that Article XIII A of the California Constitution,¹⁶⁹ which provided for a two percent cap on annual increases in assessed property valuation except for newly purchased, constructed, or transferred property, did not violate the Equal Protection Clause of the Fourteenth Amend-

practice, . . . those principles are the best system yet devised for guiding management, informing shareholders, and determining tax liability. They have the not inconsiderable virtues of consistency, regularity and certainty—virtues that also assure fairness and reasonable predictability in the Commissioner's administration of this penalty tax.”).

¹⁶⁵ 488 U.S. 336 (1989).

¹⁶⁶ *Id.* at 338.

¹⁶⁷ *Id.*

¹⁶⁸ 505 U.S. 1 (1992).

¹⁶⁹ The California voters added Article XIII A to the state constitution by a state-wide ballot initiative known as Proposition 13. *Id.* at 3–4. This 1978 initiative has been described as a “property tax revolt.” *Id.*

ment.¹⁷⁰ In those cases, the property could be assessed at its then-current market value.¹⁷¹ The Court noted, “[o]ver time, this acquisition-value system has created dramatic disparities in the taxes paid by persons owning similar pieces of property.”¹⁷² These two cases show that the Court viewed violations of systemic horizontal equity, but not violations of substantive horizontal equity, as violating the Equal Protection Clause.¹⁷³

These two cases present the horizontal equity debate in the constitutional context of the Fourteenth Amendment.¹⁷⁴ In both cases, the taxpayers successfully established that property owners with similar wealth, as measured by the value of their property, were being taxed differently by their taxing jurisdictions.¹⁷⁵ In both cases, the taxing jurisdiction discriminated against taxpayers based on the length of time the taxpayers held the property subject to tax. In *Allegheny Pittsburgh Coal*, the Court began by stating:

That two methods are used to assess property in the same class is, without more, of no constitutional moment. The Equal Protection Clause “applies only to taxation which in fact bears unequally on persons or property of the same class.” . . . In each case, the constitutional requirement is the seasonable attainment of a rough equality in tax treatment of similarly situated property owners.¹⁷⁶

¹⁷⁰ *Id.* at 10. Pointing out that “the Equal Protection Clause requires only that the classification rationally further a legitimate state interest,” *id.*, the Court held that the “[p]etitioner ha[d] not demonstrated that no rational bases lie for either of these exemptions.” *Id.* at 17. Despite recognizing the drawbacks of Article XIII A, the Court could not characterize it as “irrational” or “arbitrary”:

Certainly, California’s grand experiment appears to vest benefits in a broad, powerful, and entrenched segment of society, and, as the Court of Appeal surmised, ordinary democratic processes may be unlikely to prompt its reconsideration or repeal. Yet many wise and well-intentioned laws suffer from the same malady. Article XIII A is not palpably arbitrary, and we must decline petitioner’s request to upset the will of the people of California.

Id. at 18 (citation omitted).

¹⁷¹ *Id.* at 5.

¹⁷² *Id.* at 6.

¹⁷³ See also *Metro. Life Ins. Co. v. Ward*, 470 U.S. 869 (1985) (striking down Alabama statute which imposed substantially lower taxes on domestic insurance companies than out-of-state insurance companies).

¹⁷⁴ See also *Fitzgerald v. Racing Ass’n of Cent. Iowa*, 539 U.S. 103 (2003) (upholding, for the same reasons as those given in *Nordlinger*, a statute imposing up to a thirty-six percent tax on slot machines at racetracks, but only a twenty percent tax on slot machines on riverboats).

¹⁷⁵ See *Allegheny Pittsburgh Coal Co. v. County Comm’n*, 488 U.S. 336, 366 (1989); *Nordlinger*, 505 U.S. at 1.

¹⁷⁶ *Allegheny Pittsburgh Coal*, 488 U.S. at 343 (citations omitted).

The problem for the Equal Protection Clause and systemic and substantive horizontal equity is one of classification. If the taxpayer in *Allegheny Pittsburgh Coal* is similarly situated to his neighboring property owners, then both the Equal Protection Clause and horizontal tax equity would require equal treatment. What is needed is a test for similarly situated taxpayers. Of the two tests we have seen, systemic and substantive, the Court in both *Allegheny Pittsburgh Coal* and *Nordlinger* gravitated to the former.

The Court in *Allegheny Pittsburgh Coal* noted that a taxing jurisdiction could decide to tax property held by corporations at a different rate than property held by individuals; “[i]f the selection or classification is neither capricious nor arbitrary, and rests upon some reasonable consideration of difference or policy, there is no denial of the equal protection of the law.”¹⁷⁷ Both the laws and Constitution of West Virginia, the state taxing jurisdiction in *Allegheny Pittsburgh Coal*, provided that all property should be taxed at a uniform rate throughout the state according to its market value.¹⁷⁸ The taxpayer’s property was of the same class as its neighbors and, under state law, should have been taxed according to its market value.¹⁷⁹ This, in turn, meant that there was no state policy that supported the distinctions in tax made by the county tax assessor, and thus, the taxpayer’s claim of similarity to other property owners was sustained. Accordingly, the Court found that the West Virginia law was being applied in a way that violated the constitutional principle of equal protection.¹⁸⁰ Once a taxpayer establishes a class of taxpayers to which he belongs, disparate treatment is prohibited both by the Equal Protection Clause and by the tax principle of systemic horizontal equity.

In *Nordlinger v. Hahn*,¹⁸¹ the Court found that property owners who were distinguished from other property owners in their state on the same basis as those in *Allegheny Pittsburgh Coal* had no claim under the Equal Protection Clause.¹⁸² Unlike the taxpayer in *Allegheny Pittsburgh Coal*, the taxpayer in *Nordlinger v. Hahn* lived in a state which had expressed a rational basis for distinguishing between taxpayers who had recently purchased their property and those who had held the property for a long time.¹⁸³ The Court stated, “[t]he Equal Pro-

¹⁷⁷ *Id.* at 344.

¹⁷⁸ *Id.* at 338.

¹⁷⁹ *Id.*

¹⁸⁰ *Id.* at 343.

¹⁸¹ 505 U.S. 1 (1992).

¹⁸² *See id.* at 12.

¹⁸³ *Id.*

tection Clause does not forbid classifications. It simply keeps governmental decisionmakers from treating differently persons who are in all relevant respects alike."¹⁸⁴ Because the classification of newly purchased property was supported by rational governmental policy, the Court found that new property owners were not similarly situated to old property owners under the Equal Protection Clause.¹⁸⁵ The local county taxing authority in West Virginia offered no rational basis for differentiating between newer and older owners of property, where doing so was not authorized by state statute, thereby violating equal protection.¹⁸⁶ California had multiple rational bases for its distinction¹⁸⁷ and, thus, did not violate the Equal Protection Clause.

The method for classifying taxpayers, as a necessary prerequisite for equal protection analysis, is the turning point for the concurring opinion of Justice Thomas¹⁸⁸ and the dissenting opinion of Justice Stevens¹⁸⁹ in *Nordlinger v. Hahn*. Justice Thomas stated that "whether properties or persons are similarly situated depended on state law."¹⁹⁰ Consequently, when the State of West Virginia classified property by value and the Webster County West Virginia Assessor used the date of purchase instead of value, there was a breakdown in systemic horizontal equity that amounted to a violation of the Equal Protection

¹⁸⁴ *Id.* at 10.

¹⁸⁵ *Id.* at 12.

¹⁸⁶ *Allegheny Pittsburgh Coal*, 488 U.S. at 338 ("The Webster County tax assessor valued petitioners' real property on the basis of its recent purchase price, but made only minor modifications in the assessments of land which had not been recently sold. This practice resulted in gross disparities in the assessed value of generally comparable property, and we hold that it denied petitioners the equal protection of the laws guaranteed to them by the Fourteenth Amendment."); *see also id.* at 344-45 ("In each case, '[i]f the selection or classification is neither capricious nor arbitrary, and rests upon some reasonable consideration of difference or policy, there is no denial of the equal protection of the law.' But West Virginia has not drawn such a distinction. . . . We are not advised of any West Virginia statute or practice which authorizes individual counties of the State to fashion their own substantive assessment policies independently of state statute.") (citations and footnote omitted).

¹⁸⁷ The court stated:

The . . . exemptions at issue here rationally further legitimate purposes. The people of California reasonably could have concluded that older persons in general should not be discouraged from moving to a residence more suitable to their changing family size or income. Similarly, the people of California reasonably could have concluded that the interests of family and neighborhood continuity and stability are furthered by and warrant an exemption for transfers between parents and children.

Nordlinger v. Hahn, 505 U.S. 1, 17 (1992).

¹⁸⁸ *Id.* at 18 (Thomas, J., concurring).

¹⁸⁹ *Id.* at 28 (Stevens, J., dissenting).

¹⁹⁰ *Id.* at 22 (Thomas, J., concurring).

Clause because West Virginia tax law was not being applied consistently.¹⁹¹ Classification therefore is first evaluated under state law. If the classification into which the taxpayer is placed is rationally based, then the remaining issue is whether the taxpayer was treated consistent with state law and similarly to other members of the same class.¹⁹² That is what I have called systemic horizontal equity.

Justice Thomas, in his concurring opinion in *Nordlinger*, expressed his view that the majority believed the Webster County Assessor acted without rational basis because he acted contrary to state law.¹⁹³ In other words, the classification into which the taxpayer was placed was valid under state law, but invalid under the Equal Protection Clause, since it treated the taxpayer differently from other members of the taxpayer's class. The Court specifically viewed *Allegheny Pittsburgh Coal* as presenting a systemic problem.¹⁹⁴ The issue was consistency of category application, not whether there were other ways of classifying taxpayers. Accordingly, the Court's decision is based upon systemic horizontal equity, not substantive horizontal equity. Justice Thomas, in *Nordlinger*, focused on the Court's failure in *Allegheny Pittsburgh Coal* to declare that West Virginia could categorize property owners by date of purchase.¹⁹⁵ The problem was that the

¹⁹¹ *Id.* at 20 ("Moreover, the Court stated, the Constitution and laws of West Virginia 'provide that all property of the kind held by petitioners shall be taxed at a rate uniform throughout the State, according to its estimated market value,' and '[t]here [was] no suggestion . . . that the State may have adopted a different system in practice from that specified by statute.'" (alteration in original)).

¹⁹² *Id.* at 23 ("*Allegheny Pittsburgh*, then, does not prevent the State of California from classifying properties on the basis of their value at acquisition, so long as the classification is supported by a rational basis.").

¹⁹³ *Nordlinger v. Hahn*, 505 U.S. at 26 (Thomas, J., concurring). Justice Thomas further opined that violating state law did not make the County Assessor's classification irrational or contrary to the Equal Protection Clause. *Id.*

¹⁹⁴ See *Allegheny Pittsburgh Coal Co. v. County Comm'n*, 488 U.S. 336, 345 (1989) ("There is no suggestion in the opinion of the Supreme Court of Appeals of West Virginia, or from any other authoritative source, that the State may have adopted a different system in practice from that specified by statute; we have held that such a system may be valid so long as the implicit policy is applied even-handedly to all similarly situated property within the State."); see also *Sunday Lake Iron Co. v. Wakefield*, 247 U.S. 350, 352-53 (1918) ("[I]ntentional systematic undervaluation by state officials of other taxable property in the same class contravenes the constitutional right of one taxed upon the full value of his property."). The Court uses the adjective "systematic" in several places, but I have taken the liberty of substituting the adjective "systemic" in my analysis.

¹⁹⁵ "The Court refused to decide 'whether the Webster County assessment method would stand on a different footing if it were the law of a State, generally applied, instead of the aberrational enforcement policy it appears to be.'" *Nordlinger*, 505 U.S. at 20 (Thomas, J., concurring).

State used a different category than the County Tax Assessor.¹⁹⁶ This lack of consistency led to the violation of the Equal Protection Clause. While there may have been substantive horizontal issues presented in the case, they were not the basis of the Court's decision.

Justice Stevens agreed with the majority of the Court that the problem in *Allegheny Pittsburgh Coal* was an application problem, *de facto* rather than *de jure*, as was the problem in *Nordlinger*.¹⁹⁷ However, he parted ways with the majority over whether the California classifications in *Nordlinger* were rational.¹⁹⁸ Using the same rational basis standard articulated by the majority, Justice Stevens found the classification of property owners based upon the date of acquisition to be arbitrary and unreasonable.¹⁹⁹ He believed that the State's "neighborhood preservation" reason was not rationally furthered by classification based on date of acquisition.²⁰⁰ In support of this view, Justice Stevens offered three rationales. First, he employed horizontal and vertical tax equity analysis.²⁰¹ Second, Justice Stevens argued that the classification swept too broadly and operated too indiscriminately to rationally further the State's goal of neighborhood preservation.²⁰² Finally, Justice Stevens disagreed with the State's argument that existing property owners had a reliance interest in their current tax rates.²⁰³ This Article focuses on the first of Justice Stevens' points: that the majority of the Court has uncritically accepted the social policy goals articulated by California and simultaneously ignored the tax policy implications of the State's actions.

California adopted the classification at issue in *Nordlinger* (known as Article XIII A) by statewide ballot.²⁰⁴ This classification was intended to help alleviate the problem of taxpayers whose property values, and resulting taxes, had accelerated beyond their ability to pay.²⁰⁵ Many taxpayers purchased their property when land values

¹⁹⁶ *Id.* at 19–21.

¹⁹⁷ *Id.* at 31 (Stevens, J., dissenting).

¹⁹⁸ *Id.* at 36; *see infra* text accompanying notes 208–210, 218–223.

¹⁹⁹ *Nordlinger*, 505 U.S. at 33 (Stevens, J., dissenting).

²⁰⁰ "In short, although I agree with the Court that 'neighborhood preservation' is a legitimate state interest, I cannot agree that a tax windfall for all persons who purchased property before 1978 *rationaly* furthers that interest." *Id.* at 37.

²⁰¹ *Id.* at 33.

²⁰² *Id.* at 29–30.

²⁰³ *Id.* at 35.

²⁰⁴ *Id.* at 1 (majority opinion).

²⁰⁵ "As a result [of rising market values], tax levies continued to rise because of sharply increasing assessment values. Some homeowners saw their tax bills double or triple during this period, well outpacing any growth in their income and ability to pay." *Nordlinger*, 505 U.S. at 4.

were low, and their incomes had not increased at the same rate as the values of their properties, leaving them unable to pay a tax based on current property value.²⁰⁶ Taxpayers feared they may have to sell their homes or risk forfeiture due to failure to pay the property tax.²⁰⁷

Justice Stevens, in his dissent in *Nordlinger*, claimed that the division of property into classes distinguished by date of acquisition was arbitrary and should not pass a rational basis test.²⁰⁸

A state-wide, across-the-board tax windfall for *all* property owners and their descendants is no more a “rational” means for protecting this small subgroup [those who cannot afford higher taxes] than a blanket tax exemption for all taxpayers named Smith would be a rational means to protect a particular taxpayer named Smith who demonstrated difficulty paying her tax bill.²⁰⁹

Justice Stevens’ opinion seems to overstate the Constitutional problem. While a classification that undermines a stated goal in all respects is presumably irrational, it is much harder to claim that a classification that promotes the state’s goal in some respects is nonetheless irrational. Certainly, a majority of citizens perceived a link between classifying property by its date of purchase and property owners’ ability to pay tax upon the values so determined; a majority of the Court agreed. Given that the Court viewed itself as applying a deferential standard, it would be very difficult to find the California property tax in violation of the Equal Protection Clause of the United States Constitution.²¹⁰ However, if we limit Justice Stevens’ point to tax fairness, then perhaps it has more force.

Nordlinger differs from other cases addressed in this Article because the rule itself (Article XIII A) contains a classification being tested against Constitutional and tax fairness norms. As we have seen, the Court found that Article XIII A satisfied Constitutional requirements.²¹¹ In so finding, the Court also reached implicit conclusions about tax fairness norms. Systemic horizontal equity, as we have seen it developed by the Court, does not generally include consideration of taxpayers’ ability to pay unless it is expressed in the statute itself, as in *Correll*. Systemic horizontal equity, as employed by the Court, is content-neutral and does not include questions about

²⁰⁶ *Id.*

²⁰⁷ *Id.*

²⁰⁸ *Id.* at 32 (Stevens, J., dissenting).

²⁰⁹ *Id.* at 36.

²¹⁰ *Id.* at 11 (majority opinion).

²¹¹ “Article XIII A is not palpably arbitrary, and we must decline petitioner’s request to upset the will of the people of California.” *Nordlinger*, 505 U.S. at 18.

taxpayer wealth or income. Substantive horizontal equity, on the other hand, adds wealth and income of the taxpayer to the analysis. Even though a legislature might find criteria that would identify similarly situated taxpayers from a systemic point of view, it might nevertheless treat them differently if other criteria demonstrated that the taxpayers possessed different abilities to pay tax. The majority in *Nordlinger* viewed all California property owners as alike in all but one way: “Petitioner’s true complaint is that the State has denied her—a new owner—the benefit of the same assessment value that her neighbors—older owners—enjoy.”²¹² The Court has consistently held that distinctions that are *material* to the underlying tax policy are valid means of distinguishing similarly from differently situated taxpayers for horizontal equity consideration. In *Nordlinger*, the Court explained that if there is a rational basis for creating a statutory distinction between taxpayers, the distinction will not violate the Equal Protection Clause of the United States Constitution.²¹³ Logically, this must mean that statutory distinctions that meet the rational basis test do not violate either the Equal Protection Clause or horizontal equity, but this is not necessarily so.²¹⁴ Failure to meet horizontal equity norms should have no bearing on the constitutionality of the law,²¹⁵ but the majority implies that horizontal equity is a concern:

As between newer and older owners, Article XIII A does not discriminate with respect to either the tax rate or the annual rate of adjustment in assessments. Newer and older owners alike benefit in both the short and long run from the protections of a 1% tax rate ceiling and no more than a 2% increase in assessment value per year. New owners and old owners are treated differently with respect to one factor only—the basis on which their property is initially assessed.²¹⁶

The Court did not evaluate Article XIII A by asking about ability to pay, wealth or consumption. Instead, the Court is concerned with

²¹² *Id.* at 12.

²¹³ “We have no difficulty in ascertaining at least two rational or reasonable considerations of difference or policy that justify denying petitioner the benefits of her neighbors’ lower assessments.” *Id.*

²¹⁴ *Id.*

²¹⁵ “Of course, most laws differentiate in some fashion between classes of persons. The Equal Protection Clause does not forbid classifications. It simply keeps governmental decisionmakers from treating differently persons who are in all relevant respects alike.” *Id.* at 10.

²¹⁶ *Id.*

consistency.²¹⁷ Consistent treatment of taxpayers in a rationally devised category is all that equal protection and systemic horizontal equity require.

Justice Stevens asserted that over-inclusiveness resulted in a class with members whose ability to pay the tax (the putative criterion upon which the class was based) differed.²¹⁸ He claimed that, from the perspective of substantive tax fairness, this violated the principle of horizontal equity because the class was not horizontal.²¹⁹ In other words, while it is true that perfect congruity is not required for compliance with horizontal equity, the incongruence of the class in California was so great as to defeat even a minimal claim of similarity within the class, where similarity means ability to pay.²²⁰ Although some “early purchasers” could not afford to pay higher property taxes, such people only comprised a “small subgroup” of the population. While Article XIII A protected this small subgroup, it merely conferred a “tax windfall” on other “early purchasers” who could afford higher property taxes.²²¹ Further, as owners of commercial, industrial, vacant, and other non-residential properties were also included within the class,²²² the connection to ability to pay became even more attenuated. In Justice Stevens’ view, the State’s interest in preserving neighborhood character could not be “rationally furthered” by tax benefits for owners of non-residential properties.²²³

In addressing the under-inclusiveness of the date of purchase classification, the Court seemed to dismiss this claim by noting that new purchasers were aware that the classification would cause them to pay higher property taxes when they purchased their property.²²⁴ While this is true, the question remains whether the new purchaser is better able to pay the tax than the taxpayer who purchased in the past; knowledge that one will be assessed a higher tax has no correlation with one’s ability to pay it. Justice Stevens viewed the majority’s position as establishing a “medieval” privilege in families of equal re-

²¹⁷ The Court in *Nordlinger* distinguishes *Allegheny Pittsburgh* because of the inconsistency of application in that case. “[T]he Court found [in *Allegheny Pittsburgh*] ‘no suggestion’ that ‘the state may have adopted a different system in practice from that specified by statute.’” *Nordlinger*, 505 U.S. at 15 (quoting *Allegheny Pittsburgh Coal Co. v. County Comm’n*, 488 U.S. 336, 343 (1989)).

²¹⁸ *Id.* at 35 (Stevens, J., dissenting).

²¹⁹ *Id.* at 29–31.

²²⁰ *Id.*

²²¹ *Id.* at 35–36.

²²² *Id.* at 36.

²²³ *Nordlinger*, 505 U.S. at 36 (Stevens, J., dissenting).

²²⁴ *Id.* at 12–13 (majority opinion).

sources who are treated differently solely because of their different heritage.²²⁵ In other words, as between two families with equal economic resources available to pay for government goods and services through a property tax, the family whose ancestors had purchased the property first would pay the lower tax. For Justice Stevens, Article XIII's classification "offend[ed] a policy of equal tax treatment for taxpayers in similar situations"²²⁶

Summarizing Justice Stevens' view, classifications used to distinguish taxpayers should be based upon their ability to pay (substantive horizontal equity), rather than on the date they purchased their property. Justice Stevens believed that both tax fairness and the Equal Protection Clause require courts to focus on ability to pay in analyzing tax statutes and classifications. Further, the California classification system did not advance the justifications given by the State for the classes it created.

The majority believed that the classifications furthered California's legitimate interests and therefore complied with the demands of the Equal Protection Clause.²²⁷ This disagreement is at the heart of any horizontal equity tax fairness debate. No one argues that similarly situated taxpayers should be treated dissimilarly. The issue is what counts as similar. The Court has only once used ability to pay in its horizontal equity analysis.²²⁸ In *Correll*, the Court allowed ability to pay, or more accurately levels of consumption, to be considered in interpreting § 162 of the Code.²²⁹ Except in *Correll*, the Court has never used ability to pay as an element of horizontal equity. The Court has never decided whether taxpayers are similar or different on that basis. Seemingly, differences based upon ability to pay will not be viewed by the Court as valid statutory construction criteria, unless the statute itself raises that concern as it did in *Correll*.²³⁰

²²⁵ *Id.* at 30 (Stevens, J., dissenting).

²²⁶ *Id.*

²²⁷ *Id.* at 12 (majority opinion).

²²⁸ *United States v. Correll*, 389 U.S. 299, 302-04 (1967).

²²⁹ *Id.*

²³⁰ *But see* Miller, *supra* note 13, at 126. Professor Miller argued that the Court in *Nordlinger* violated horizontal equity principles. His view was that using income, consumption, or wealth as indices of equality, the California law can be shown to violate horizontal equity. *Id.* at 126-27. My view is slightly different. I contend that in the context of statutory interpretation, the Court views those criteria as more closely related to vertical equity, and that horizontal equity, at least as it is viewed by the Court, is content-neutral. Other than *Correll*, the Court has not employed substantive horizontal equity (income, wealth, or consumption) in statutory interpretation and seems to reject it in *Nordlinger's* Equal Protection Clause analysis.

Justice Thomas stated in *Nordlinger* that:

Allegheny Pittsburgh assumed that whether properties or persons are similarly situated depended on state law, and not, as petitioner argues, on some neutral criteria such as size or location that serve as proxies for market value. Under that theory, market value would be the *only* rational basis for classifying property.²³¹

In other words, while a taxing jurisdiction might use property value as a proxy for ability to pay, it need not. Moreover, failure to use property value as a distinguishing characteristic is not irrational and does not necessarily violate the Equal Protection Clause.²³² Finally, if horizontal equity requires simply that taxpayers be classified on a rational basis and that taxpayers in the same class are similar, then horizontal equity is also not violated by the classification system used by Article XIII A.

California citizens wanted a law that would ameliorate some of the problems connected with some taxpayers' abilities to pay their property tax. The *Nordlinger* majority held that California crafted a law that furthered that objective.²³³ The fact that the law might have been better drawn to help more taxpayers does not mean that the one adopted was irrational or that it violated systemic horizontal equity principles. Instead, the complaint is that California could have done a better job of classifying taxpayers on the basis of ability to pay. The law could have created categories that more closely tracked ability to pay, and thus, the California law is best criticized as violating substantive horizontal equity principles. A violation of substantive horizontal equity does not transform into a violation of equal protection or systemic horizontal equity.

From *Nordlinger*, I conclude that the Court generally excludes substantive horizontal equity principles from its horizontal equity analysis. Comparative wealth, income, and consumption are relevant in creating classifications of taxpayers, but once a classification has been established, those concerns recede, and the analysis shifts to whether the classification criteria are rational and consistently applied.

²³¹ *Nordlinger*, 505 U.S. at 22 (Thomas, J., concurring).

²³² *Id.* at 12 (majority opinion).

²³³ *Id.* at 18.

VI. THE ROLE OF FAIRNESS IN INTERPRETING TAX ISSUES UNDER THE COMMERCE CLAUSE OF THE UNITED STATES CONSTITUTION

Article I, Section 8, clause 3 of the Constitution, commonly known as the Commerce Clause, states that Congress shall have the power to “regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes.”²³⁴ From this, the Court developed a concept known as the Dormant Commerce Clause.²³⁵ The Court uses the Dormant Commerce Clause to provide a level playing field for interstate commerce, free from undue interference from the states.²³⁶ This goal is essentially a fairness inquiry. Restated, the Court applies the Dormant Commerce Clause to prevent one state from unfairly restricting trade in a way that favors its citizens over citizens of another state. The Court has applied the Dormant Commerce Clause analysis to situations involving the imposition of taxes upon interstate transactions by states.²³⁷ In this section of the Article, I will examine Supreme Court cases that have spoken to Commerce Clause issues in the context of taxation of interstate transactions. In my view, these cases show that the Court is expanding its fairness jurisprudence to include not only horizontal equity but also vertical equity norms.

The Court employs a fairness analysis when addressing two distinct constitutional questions concerning state taxation of businesses engaged in interstate commerce. First, the Court discusses fairness in the context of the Due Process Clause of the Fourteenth Amendment.²³⁸ Second, the Court discusses fairness in the context of the Commerce Clause.²³⁹ Although there are substantial similarities between the Due Process Clause fairness concerns and those raised by the Commerce Clause, the Court pointed out that, “[d]espite the similarity in phrasing, the nexus requirements of the Due Process and

²³⁴ U.S. CONST. art. I, § 8, cl. 3.

²³⁵ “Under what has come to be known as ‘dormant’ Commerce Clause Doctrine, certain state measures regulating or taxing interstate commerce are deemed constitutionally prohibited unless Congress has affirmatively authorized the states so to regulate or to tax that interstate commerce.” 1 LAURENCE H. TRIBE, *AMERICAN CONSTITUTIONAL LAW* 203 (3d ed. Foundation Press 2000). The first case to raise this point was *Gibbons v. Ogden*, 22 U.S. (9 Wheat.) 1 (1824).

²³⁶ See *Freeman v. Hewit*, 329 U.S. 249, 252 (1946).

²³⁷ See TRIBE, *supra* note 235, at 203.

²³⁸ *Quill Corp. v. North Dakota*, 504 U.S. 298, 312 (1992) (“Due process centrally concerns the fundamental fairness of governmental activity.”).

²³⁹ *Id.* at 313 (“The second and third parts of [the Commerce Clause] analysis, which require fair apportionment and non-discrimination, prohibit taxes that pass an unfair share of the tax burden onto interstate commerce.”).

Commerce Clauses are not identical.”²⁴⁰ Due process is concerned with notice to the taxpayer.²⁴¹ Due process requires fair warning that the taxpayer is subject to the taxing jurisdiction of the state.²⁴² The Commerce Clause is concerned with the structural effects of state regulation on the national economy.²⁴³ In other words, the Commerce Clause requirements reflect tax fairness policy, while Fourteenth Amendment Due Process Clause fairness is broader and addresses process fairness questions rather than tax fairness questions. Accordingly, although the Court has used fairness in both its Due Process Clause and its Commerce Clause jurisprudence, I will confine my inquiry to the Supreme Court’s Commerce Clause analysis.²⁴⁴

In *Complete Auto Transit, Inc. v. Brady*,²⁴⁵ the Court synthesized its prior jurisprudence on state taxation and the Commerce Clause, and articulated a four-part test to be applied in analyzing whether a state tax levied on interstate commerce complies with the Commerce Clause. In reviewing its prior decisions, the Court observed that:

These decisions have considered not the formal language of the tax statute but rather its practical effect, and have sustained a tax against Commerce Clause challenge when the tax is applied to an activity with a substantial nexus with the taxing State, is fairly ap-

²⁴⁰ *Id.* at 312.

²⁴¹ “[T]he ‘substantial nexus’ requirement [under the Commerce Clause] is not, like due process’ ‘minimum contacts’ requirement, a proxy for notice, but rather a means for limiting state burdens on interstate commerce.” *Id.* at 313.

²⁴² “Comparable reasoning justifies the imposition of the collection duty on a mail-order house that is engaged in continuous and widespread solicitation of business within a State. Such a corporation clearly has ‘fair warning that [its] activity may subject [it] to the jurisdiction of a foreign sovereign.’” *Id.* at 308 (alteration in original) (citation omitted).

²⁴³ *Id.* at 312.

²⁴⁴ In his dissent in *General Motors Corp. v. Washington*, Justice Brennan explained that:

In order to tax any transaction, the Due Process Clause requires that a State show a sufficient “nexus between such a tax and transactions within a state for which the tax is an exaction.” This question . . . is the most fundamental precondition on state power to tax. But the strictures of the Constitution on this power do not stop there. For in the case of a gross receipts tax imposed upon an interstate transaction, even though the taxing State can show “some minimum connection,” the Commerce Clause requires that “[t]axation measured by gross receipts from interstate commerce . . . [be] fairly apportioned to the commerce carried on within the taxing state.”

377 U.S. 436, 449–50 (1964) (Brennan, J., dissenting) (citations omitted).

²⁴⁵ 430 U.S. 274 (1977).

portioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the State.²⁴⁶

My interest lies in the meaning the Court gives to the third and fourth elements of its test, with particular interest in the fourth. The third element, non-discrimination, is a systemic horizontal equity claim.²⁴⁷ The fourth element, fair relation to services provided, is vertical in that it asks whether the taxpayer is taxed at levels consistent with the services the state provides him. The fourth element asks whether the taxpayer is contributing more, less, or the same than he would be required to pay if he were paying the state directly for the services provided.

A. *Tax Fairness, Horizontal Equity, and the Commerce Clause*

In *Wealth of Nations*, Adam Smith wrote:

When the carriages which pass over a highway or a bridge, and the lighters which sail upon a navigable canal, pay toll in proportion to their weight or their tunnage, they pay for the maintenance of those public works exactly in proportion to the wear and tear which they occasion of them. It seems scarce possible to invent a more equitable way of maintaining such works.²⁴⁸

This ancient problem of how best to allocate the expenses of commerce to those who benefit from the services has given rise to the Supreme Court's Commerce Clause tax fairness jurisprudence. While the Court may start from the principle of proportionality that Smith advocates, it eventually expands upon that basis to include larger questions of distributive justice.

In *Freeman v. Hewit*,²⁴⁹ the Supreme Court addressed the question of whether the State of Indiana could levy a one percent tax on a transaction by an Indiana resident on the New York Stock Exchange. The Court found that the tax violated the Commerce Clause.²⁵⁰ The third element of the *Complete Auto* standard requires that the tax not discriminate against interstate commerce.²⁵¹ This is a horizontal equity analysis since it asks whether there is an identifiable group of taxpayers who are similarly situated but differently treated so as to

²⁴⁶ *Id.* at 279 (citations omitted).

²⁴⁷ Under the decisions discussed below, a state may not discriminate against foreign competitors in favor of in-state businesses. This is a systemic claim because the analysis is based upon consistency rather than ability to pay, wealth, or consumption.

²⁴⁸ SMITH, *supra* note 2, at 475.

²⁴⁹ 329 U.S. 249 (1946).

²⁵⁰ *Id.* at 257-58.

²⁵¹ *Id.* at 257.

provide one with a marketplace advantage over the other. In *Freeman*, the Court stated:

It has been suggested that such a tax is valid when a similar tax is placed on local trade, and a specious appearance of fairness is sought to be imparted by the argument that interstate commerce should not be favored at the expense of local trade. So to argue is to disregard the life of the Commerce Clause. Of course a State is not required to give active advantage to interstate trade. But it cannot aim to control that trade even though it desires to control its own. It cannot justify what amounts to a levy upon the very process of commerce across States lines by pointing to a similar hobble on its local trade.²⁵²

The Commerce Clause does not require that in-staters be treated identically with out-of-staters.²⁵³ Accordingly, the Court rejected the horizontal equity claim that would allow state impediments to interstate commerce if the state similarly impeded intrastate commerce.²⁵⁴

Although the Court rejected the equal impediment horizontal equity claims in *Freeman*, and refused to allow the fact that intrastate sales of the type transacted interstate by *Freeman* would have been subject to the same tax, to justify imposition of such a tax the Court uses horizontal equity analysis when the claim is reversed.²⁵⁵ For example, in *American Trucking Associations, Inc. v. Scheiner*,²⁵⁶ the Court held that a tax levied by Pennsylvania only on foreign-registered trucks violated the third element of the *Complete Auto* standard.²⁵⁷ In other words, treating out-of-state taxpayers like in-state taxpayers will not insulate the state against a Dormant Commerce Clause claim, but treating out-of-state taxpayers worse than in-state taxpayers will trigger such a claim.

Through its decisions in *Complete Auto*, *Freeman*, and *Scheiner*, the Court settled the horizontal component of tax fairness under the Commerce Clause. Under the third element of the *Complete Auto* standard, the state may not discriminate against foreign competitors in favor of in-state business. That principal is reinforced with the

²⁵² *Id.* at 254.

²⁵³ *Id.*

²⁵⁴ *Id.* (“It is true that the existence of a tax on its local commerce detracts from the deterrent effect of a tax on interstate commerce to the extent that it removes the temptation to sell the goods locally. But the fact of such a tax, in any event, puts impediments upon the currents of commerce across the State line . . .”).

²⁵⁵ *Freeman*, 329 U.S. at 255 (“To extract a fair tithe from interstate commerce for the local protection afforded to it, a seller State need not impose the kind of tax which Indiana here levied.”).

²⁵⁶ 483 U.S. 266 (1987).

²⁵⁷ *Id.* at 277; *see infra* notes 245–46 and accompanying text.

practical illustration of Pennsylvania's attempt at taxing foreign trucking companies while exempting domestic trucking companies from the same levy. *Scheiner* rejects that tax as unfair to interstate commerce because it discriminates against foreign, similarly situated taxpayers. The converse, however, is not true. Under *Freeman*, a tax on similarly situated domestic businesses will not, of itself, permit the tax to be extended to foreign business. Something more is required. The Court left open the door for taxes similar to those imposed by Indiana in *Freeman* to be justified if they are imposed to ensure that commerce bears its fair share of the cost of local government.²⁵⁸ Bearing a "fair share" of the tax burden can be seen as a corollary to horizontal tax equity, but it is more often viewed as the separate norm of vertical equity.²⁵⁹

B. Tax Fairness, Vertical Equity, and the Commerce Clause

The fairness argument, grounded in the third element of the *Complete Auto* test, was addressed in *Freeman*. There, the Court rejected the appeal to horizontal equity fairness but agreed with the appeal to distributional fairness when it stated: "State taxation falling on interstate commerce, on the other hand, can only be justified as designed to make such commerce bear a fair share of the cost of the local government whose protection it enjoys."²⁶⁰ The connection between taxes paid and services provided is the fairness link the Court identifies as the essence of the fairness question posed by the Commerce Clause under the fourth element of the *Complete Auto* test.²⁶¹

The Court advanced its theory of distributive fairness in *Capitol Greyhound Lines v. Brice*,²⁶² in which passenger bus companies challenged the imposition of an excise tax by the State of Maryland on the value of buses operated in the state. The Court upheld the tax, reasoning that:

Complete fairness would require that a state tax formula vary with every factor affecting appropriate compensation for road use. These factors, like those relevant in considering the constitution-

²⁵⁸ *Freeman*, 329 U.S. at 253.

²⁵⁹ See *supra* note 4 and accompanying text.

²⁶⁰ *Freeman*, 329 U.S. at 253.

²⁶¹ *Id.* at 256 ("These illustrative instances show that a seller State has various means of obtaining legitimate contribution to the costs of its government, without imposing a direct tax on interstate sales. While these permitted taxes may in an ultimate sense, come out of interstate commerce, they are not, as would be a tax on gross receipts, a direct imposition on that very freedom of commercial flow which for more than a hundred and fifty years has been the ward of the Commerce Clause.")

²⁶² 339 U.S. 542 (1950).

ality of other state taxes, are so countless that we must be content with “rough approximation rather than precision.” . . . Upon this type of reasoning rests our general rule that taxes like that of Maryland here are valid unless the amount is shown to be in excess of fair compensation for the privilege of using state roads.²⁶³

The Court in *Capitol Greyhound Lines* began a journey on the road to modern vertical tax fairness. As the quotation above illustrates, the Court wanted to connect the amount each taxpayer paid to the governmental services used by that taxpayer. This is the very foundation of vertical equity—the notion that similarly situated taxpayers should be treated similarly, but that material differences should result in material differences in tax. Similarity means more than just the substantive horizontal question of comparative wealth of the taxpayer; it must also include the comparative advantage obtained by a taxpayer in exchange for the tax paid. That calculus cannot begin until there is some attempt at determining what benefits can rightfully be associated with a particular taxpayer. With that information, it can be known whether the taxpayer is underpaying or overpaying for the services received. From there, it can be determined whether the taxpayer is being treated differently from other similarly situated taxpayers or differently from other differently situated taxpayers.

Substantive horizontal tax equity is foundational to any notion of vertical tax equity. Questions about what constitutes equal levels of income, wealth, and consumption, which make up substantive horizontal equity, precede questions about the differences that may require different rates of tax under vertical equity. Under the Commerce Clause, the first inquiry for the Court concerns the state’s claim for payment for services rendered to out-of-state taxpayers who use state facilities such as roads.²⁶⁴ If consumption of state services

²⁶³ *Id.* at 546–47 (citations omitted).

²⁶⁴ *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977) announced what became known as the *Complete Auto Test*.

“[I]t was not the purpose of the commerce clause to relieve those engaged in interstate commerce from their just share of state tax burden even though it increases the cost of doing business.” These decisions have considered not the formal language of the tax statute but rather its practical effect, and have sustained a tax against Commerce Clause challenge when the tax is applied to an activity with a substantial nexus with the taxing State, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the State.

Id. (quoting *W. Live Stock v. Bureau of Revenue*, 303 U.S. 250, 254 (1938)) (footnote omitted).

can be shown, the inquiry under the *Capitol Greyhounds Lines* test shifts to whether the tax is fairly related to the level of services provided by the state.²⁶⁵

Apportionment, the second element of *Complete Auto*, looks to whether the state is seeking to tax income unrelated to the nexus that gives rise to the opportunity to tax in the first place.²⁶⁶ In other words, if a bus company earned ten percent of its income from journeys that passed through a given state, the maximum amount of the taxpayer's income that could be subject to the taxing authority of that state would be ten percent.²⁶⁷ The fourth element of the *Complete Auto* test, fair relation to services provided, checks against over-taxation by multiple jurisdictions by limiting tax to amounts connected with the services provided.²⁶⁸

²⁶⁵ "This Court and others have consistently upheld taxes on interstate carriers to compensate a state fairly for the privilege of using its roads or for the cost of administering state traffic regulations." *Capitol Greyhound Lines*, 339 U.S. at 543-44.

²⁶⁶ *Goldberg v. Sweet*, 488 U.S. 252, 261-62 (1989).

[W]e determine whether a tax is fairly apportioned by examining whether it is internally and externally consistent.

To be internally consistent, a tax must be structured so that if every State were to impose an identical tax, no multiple taxation would result. Thus, the internal consistency test focuses on the text of the challenged statute and hypothesizes a situation where other States have passed an identical statute. . . .

The external consistency test asks whether the State has taxed only that portion of the revenues from the interstate activity which reasonably reflects the interstate component of the activity being taxed. We thus examine the in-state business activity which triggers the taxable event and the practical or economic effect of the tax on that interstate activity.

Id.

²⁶⁷ This is the reason behind the Court's concern in *Oklahoma Tax Commission v. Jefferson Lines, Inc.*, 514 U.S. 175, 179 (1995), that a tax on gross income would be impermissible because it would tax income unrelated to business in a given state and subject the taxpayer to multiple taxation from multiple states on a given amount of income.

²⁶⁸ For example, in *Oklahoma Tax Commission*, the Court stated:

The fair relation prong of *Complete Auto* requires no detailed accounting of the services provided to the taxpayer on account of the activity being taxed, nor, indeed, is a State limited to offsetting the public costs created by the taxed activity. If the event is taxable, the proceeds from the tax may ordinarily be used for purposes unrelated to the taxable event. Interstate commerce may thus be made to pay its fair share of state expenses and contribute to the cost of providing all governmental services, including those services from which it arguably receives no direct benefit. The bus terminal may not catch fire during the sale, and no robbery there may be foiled while the buyer is getting his ticket, but police and fire protection, along with the usual and usually forgotten advantages conferred by the State's maintenance of a

The road to vertical tax fairness, on which the court embarked in *Capitol Greyhound Lines*, concerns the appropriate boundaries for determining what the taxpayer should pay as “appropriate compensation for road use.”²⁶⁹ The Court recognized the difficulty in enumerating the proper charges that the taxpayer should pay, but the Court also recognized the necessity for making such a determination. Because of this difficulty, the Court cabined the issue and limited the inquiry to charges connected with the use of state roads.²⁷⁰ Subsequent Court decisions expanded that inquiry to include other services from which taxpayers also benefit while within a state.

In *Evansville-Vanderburgh Airport Authority District v. Delta Airlines, Inc.*,²⁷¹ the Court uncoupled the connection between the taxes paid by out-of-state taxpayers from any requirement that those specific funds be restricted exclusively to the use for which they were collected.²⁷² This is not to say that the amounts collected by the state may exceed the total costs incurred by the state on behalf of the out-of-state taxpayer; they may not. Instead, the state may expand the list of services beyond those directly connected to the activity of the out-of-state taxpayer, and the state need not show a direct path from the taxpayer to the purchase of specific services.²⁷³ Thus, one could view all taxes paid as fungible. There is no direct link between the reimbursement by a taxpayer for his share of an expense and the direction of funds paid by the taxpayer into an account dedicated to that expense. The root inquiry is fairness, and the connection between the cost incurred by the state on behalf of the out-of-state taxpayer and the amounts paid by that taxpayer is a measure of fairness, not a promise to segregate taxpayer payments.

civilized society, are justifications enough for the imposition of a tax. *Complete Auto's* fourth criterion asks only that the measure of the tax be reasonably related to the taxpayer's presence or activities in the State.

Id. at 199–200 (citations and internal quotation marks omitted).

²⁶⁹ “Complete fairness would require that a state tax formula vary with every factor affecting appropriate compensation for road use.” *Capitol Greyhound Lines*, 339 U.S. at 546.

²⁷⁰ “These factors, like those relevant in considering the constitutionality of other state taxes, are so countless that we must be content with ‘rough approximation rather than precision.’ . . . Upon this type of reasoning rests our general rule that taxes like that of Maryland here are valid unless the amount is shown to be in excess of fair compensation for the privilege of using state roads.” *Id.* at 546–47.

²⁷¹ 405 U.S. 707 (1972).

²⁷² *Id.* at 720 (“Yet so long as the funds received by local authorities under the statute are not shown to exceed their airport costs, it is immaterial whether those funds are expressly earmarked for airport use.”).

²⁷³ *Id.*

In *Goldberg v. Sweet*,²⁷⁴ the Court applied the fourth prong of the *Complete Auto* test (the tax must be fairly related to the taxpayer's activities within the state) by expanding the scope of activities that could be considered beyond those directly tied to the taxpayer's activity. The test's purpose is to ensure that a State's tax burden is not placed upon persons who do not benefit from the services provide by the State. The Court stated:

Finally, we reach the fourth prong of the *Complete Auto* test, namely, whether the Illinois tax is fairly related to the presence and activities of the taxpayer within the State. The purpose of this test is to ensure that a State's tax burden is not placed upon persons who do not benefit from services provided by the State.

Appellants would severely limit this test by focusing solely on those services which Illinois provides to telecommunications equipment located within the State. We cannot accept this view. The tax which may be imposed on a particular interstate transaction need not be limited to the cost of the services incurred by the State on account of that particular activity. On the contrary, "interstate commerce may be required to contribute to the cost of providing *all* governmental services, including those services from which it arguably receives no direct 'benefit.'" The fourth prong of the *Complete Auto* test thus focuses on the wide range of benefits provided to the taxpayer, not just the precise activity connected to the interstate activity at issue. Indeed, last Term . . . , we noted that a taxpayer's receipt of police and fire protection, the use of public roads and mass transit, and the other advantages of civilized society satisfied the requirement that the tax be fairly related to benefits provided by the State to the taxpayer.²⁷⁵

Here, the Court wanted to prevent out-of-staters from getting a free ride with respect to the services provided by the State.²⁷⁶ By expanding the class of services that could be considered in determining whether the taxpayer was paying his fair share, the Court enhanced fairness by preventing taxpayers from receiving services without being charged. The Court also made the analysis of fairness more difficult by sweeping in fractions of state services that are more difficult to accurately determine. It might be possible, for example, to approximate the percentage of the cost of highway services provided to a taxpayer who uses a highway for a known period of time, but it

²⁷⁴ 488 U.S. 252 (1989).

²⁷⁵ *Id.* at 266–67 (citations omitted).

²⁷⁶ "Indeed, last Term . . . we noted that a taxpayer's receipt of police and fire protection, the use of public roads and mass transit, and the other advantages of civilized society satisfied the requirement that the tax be fairly related to benefits provided by the State to the taxpayer." *Id.* at 267.

would be much more difficult to determine the appropriate fraction of police services for which the out-of-state taxpayer should pay.

In *The Myth of Ownership*, Liam Murphy and Thomas Nagel argue for a vision of tax policy that addresses not only ability to pay, measured in the historical standards of vertical equity, but also by including of the full range of benefits and burdens supplied by, or made possible by, government.²⁷⁷ Under this approach, if one is taxed ten dollars but is then provided with ten dollars worth of social security benefit, police protection, farm subsidy, or roads, it is hard to see any tax burden at all. Instead, one sees merely a payment for goods, cash, or services.²⁷⁸ It appears that the Supreme Court has taken a few steps on this same road by linking Commerce Clause fairness to a showing by the State of the goods and services connected to the tax imposed upon out-of-state taxpayers.

In *Goldberg v. Sweet*, the Court stated that in evaluating fairness it is necessary to examine all governmental services received by a taxpayer.²⁷⁹ Thus, a taxpayer who provides telecommunications services within a state must pay not only for the services provided by the State which can be tied directly to the taxpayer's activities, but also the cost of all government services provided to all who conduct any business within the state.²⁸⁰ The taxpayer must pay the indirect costs of conducting business in a state in addition to the direct costs.

The distinction between direct and indirect costs does not imply that indirect costs are less worthy of being borne by those who transact business within a state. The Court indicated that indirect costs may be considered in the calculation of whether a tax fairly burdens a taxpayer under the Commerce Clause.²⁸¹ Indirect costs are by no

²⁷⁷ MURPHY & NAGEL, *supra* note 3, at 14–15 (“First, theories of vertical equity are frequently myopic, in that they attempt to treat justice in taxation as a separate and self-contained political issue. The result is not a partial account of justice in government, but rather a false one. For what counts as justice in taxation cannot be determined without considering how government allocates its resources.”).

²⁷⁸ This is also an extension of Rawlsian notions of distributive justice. See Sugin, *supra* note 25; see also Musgrave, *supra* note 10, at 16.

²⁷⁹ *Goldberg*, 488 U.S. at 267 (“[T]he Tax Act is fairly related to the benefits received by Illinois telephone consumers. The benefits that Illinois provides cannot be limited to those exact services provided to the equipment used during each interstate telephone call. Illinois telephone consumers also subscribe to telephone service in Illinois, own or rent telephone equipment at an Illinois address, and receive police and fire protection as well as the other general services provided by the State of Illinois.”).

²⁸⁰ “[I]nterstate commerce may be required to contribute to the cost of providing all governmental services, including those services from which it arguably receives no direct benefit.” *Id.* (internal quotation marks omitted).

²⁸¹ *Id.*

means small or inconsequential. They may be significantly higher than the direct costs of services provided by government, but far less obvious or simple to compute. The method of computation of indirect costs presents the next fairness problem for the Court.

In *Massachusetts v. United States*,²⁸² the Court decided whether an annual registration tax, imposed on all civil aircraft that fly in the United States' navigable airspace, could be applied to Massachusetts.²⁸³ Noting one of the "two attributes of the taxing power," the Court stated that "in imposing a tax to support the services a government provides to the public at large, a legislature need not consider the value of particular benefits to a taxpayer, but may assess the tax solely on the basis of taxpayers' ability to pay."²⁸⁴

As indicated earlier, Murphy and Nagel view traditional vertical tax equity analysis as insular and divorced from serious distributive justice analysis.²⁸⁵ However, in *Massachusetts v. United States*, the Court endorsed the use of substantive horizontal equity principles to protect the integrity of vertical equity norms.²⁸⁶ Implementing this approach, the Supreme Court had to determine whether the tax fairly reflected the amount of benefit received.²⁸⁷ In the end, the Court allowed taxing jurisdictions to charge out-of-state taxpayers for their distributive share of every service the state provides, even though a precise calculation of that share's value is not required, because it found that the tax fairly reflected the benefit received.²⁸⁸ Although this analysis is a necessary step on the road to vertical equity in the distributive justice model, how far the Court may proceed down this road remains to be seen.

²⁸² 435 U.S. 444 (1978).

²⁸³ See *id.* at 446.

²⁸⁴ *Id.* at 455 (plurality opinion); see also *Nat'l Cable Television Ass'n, Inc. v. United States*, 415 U.S. 336, 340 (1974) ("Taxation is a legislative function, and Congress, which is the sole organ for levying taxes, may act arbitrarily and disregard benefits bestowed by the Government on a taxpayer and go solely on ability to pay, based on property or income. A fee, however, is incident to a voluntary act, e.g., a request that a public agency permit an applicant to practice law or medicine or construct a house or run a broadcast station.")

²⁸⁵ MURPHY & NAGEL, *supra* note 3, 14–15. Vertical equity norms require the taxing jurisdiction to lay taxes based upon ability to pay, whereas substantive horizontal equity norms require that members of the classes selected by the taxing jurisdiction be similarly situated in their ability to pay. Systemic horizontal equity ensures consistent application of the rule.

²⁸⁶ *Massachusetts v. United States*, 435 U.S. at 468–69.

²⁸⁷ See *id.*

²⁸⁸ See *id.*

VII. CONCLUSION

The cases covered herein demonstrate that the Court has followed two separate lines of jurisprudence in applying tax fairness norms. One line concerns statutory construction and the other addresses fairness in the Commerce Clause context. In construing tax statutes, the Court has employed two different fairness norms based upon legislative horizontal equity principles. The first norm, systemic horizontal equity, is content-neutral and resolves tax fairness questions on the basis of consistency, regularity, and certainty. The second norm, substantive horizontal equity, which is applied less frequently, is content-specific, and resolves questions of tax fairness through inquiry into income, wealth, and consumption. The second line of fairness jurisprudence applies both types of horizontal equity and introduces a strain of vertical equity by assessing the degree to which taxpayers, subject to the Commerce Clause, pay for the services they receive from a given state in exchange for the taxes they pay. This is the first step in any analysis that seeks to evaluate whether a taxpayer is over- or under-taxed relative to income compared to services received because it establishes a baseline amount to determine whether a taxpayer is paying more or less than other taxpayers for services received. Accordingly, it invokes legislative questions such as redistribution of wealth and progressive income taxation.

A brief review of the cases covered in this Article shows that in both *Correll*²⁸⁹ and *First Security Bank*,²⁹⁰ the Court recognized that fairness required consistent treatment among taxpayers. There, the Court looked for consistency with other federal laws (both tax and non-tax) and congruency with the legislative purpose. Consistent with systemic horizontal equity, these two factors are used by the Court to identify similarly situated taxpayers. In *Correll*, the Court also examined the statute's content to determine whether taxpayers were similarly situated with respect to their ability to pay.²⁹¹ This is the only time the Court has used substantive horizontal equity to resolve questions of fairness in interpreting tax statutes.

In *Groetzing*, the Court viewed the continuity, regularity, and primary purpose of the taxpayer's gambling as distinguishing him from similarly situated taxpayers (those in the category of "taxpayers who gamble") for whom gambling was but "a sporadic activity, a

²⁸⁹ United States v. Correll, 389 U.S. 299, 303 (1967).

²⁹⁰ Comm'r v. First Sec. Bank of Utah, N.A., 405 U.S. 394, 407 (1972).

²⁹¹ See *Correll*, 389 U.S. at 304–06.

hobby, or an amusement diversion.”²⁹² The degree to which this taxpayer filled the category changed the category itself (introducing a subcategory of “taxpayers for whom gambling is a ‘trade or business’”), so that one who occasionally gambles is not in the “trade or business” of being a gambler, but, like the taxpayer in *Groetzinger*, one who earns a living through gambling is.²⁹³

In *Allegheny Pittsburgh Coal*²⁹⁴ and *Nordlinger*,²⁹⁵ the Court confirmed its interest in applying systemic horizontal equity to the exclusion of substantive horizontal equity. These two cases illustrate that the Court will use systematic horizontal equity concerns such as consistency, regularity, and certainty to evaluate the fairness of tax legislation, rather than substantive horizontal concerns such as ability to pay as measured by income, wealth or consumption to determine the fairness of tax legislation.

The Court’s Commerce Clause tax fairness analysis illustrates a progression toward current vertical equity analysis. In *Goldberg*, the Court endorsed distributive fairness by taking into account the benefits a taxpayer received in evaluating the fairness of the tax imposed on the taxpayer.²⁹⁶ However, the Court rejected a simpler analysis that looked only to cash transfers and income distribution in judging the fairness of tax burdens on taxpayers.²⁹⁷ Thus, the Court implied that the problem of identifying the goods and services that should count, though difficult, are necessary to seriously consider income and wealth distributions in American society.²⁹⁸

In these cases and others, the Supreme Court addressed horizontal tax equity in administrative rulings by applying statutes of limitations, for example, in ways that ignore the distinction between the government and the taxpayer.²⁹⁹ The Court also split horizontal equity into its two constituent components, systemic and substantive horizontal equity, in these cases. As the Court indicated, this distinction turns on the definition of substantive horizontal equity as similarity among taxpayers in terms of income, wealth, or consump-

²⁹² See *Comm’r v. Groetzinger*, 480 U.S. 23, 35 (1987).

²⁹³ *Id.*

²⁹⁴ See *Allegheny Pittsburgh Coal Co. v. County Comm’n*, 488 U.S. 336, 343 (1989).

²⁹⁵ See *Nordlinger v. Hahn*, 505 U.S. 1, 32 (1992) (Stevens, J., dissenting).

²⁹⁶ See *Goldberg v. Sweet*, 488 U.S. 252, 266–67 (1989).

²⁹⁷ See *id.* at 267.

²⁹⁸ See *Massachusetts v. United States*, 435 U.S. 444, 469 (1978).

²⁹⁹ See *Rothensies v. Electric Storage Battery Co. (Electric Storage Battery IV)*, 329 U.S. 296, 301 (1946).

tion,³⁰⁰ and the definition of systemic horizontal equity similarity among taxpayers based upon consistency, regularity, and certainty.³⁰¹

The preference for systemic horizontal equity is a useful check on what could otherwise be an unwieldy, ad hoc approach to the resolution of tax disputes. Systemic horizontal equity analysis allows the Court to do what it does best: analyze fairness on the basis of readily ascertainable administrative consistency, regularity, and certainty, rather than on the frequently elusive substantive horizontal equity norms of income, wealth, and consumption. By dividing the tax fairness principle of horizontal equity into these two branches, the Court ensured that similarly situated taxpayers would be treated similarly in the primary areas of judicial concern: consistency, regularity, and certainty.

In its tax fairness jurisprudence under the Commerce Clause, the Court has established the need for preliminary analysis concerning the relationship between taxes paid and services received in evaluating vertical tax equity. While enormously difficult, it seems that analysis of this relationship is a necessary precondition to evaluation of progressive taxation. Such analysis may prove less difficult in the future as proxies are found that adequately substitute for detailed individual analysis of the value obtained by taxpayers in exchange for their tax payments.

³⁰⁰ See, e.g., *Ivan Allen Co. v. United States*, 422 U.S. 617, 641–42 (1975).

³⁰¹ See *United States v. Correll*, 389 U.S. 299, 304–06 (1976).