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Preventive Tax Policy: Chief Justice Roger J. Traynor's Tax Philosophy

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by

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Abstract

Justice Roger J. Traynor is best known for his judicial innovations in the fields of conflict of laws, product liability, and civil procedure. However, few would trace Traynor's roots to the field of tax law. In the late 1930's Traynor collaborated with Stanley S. Surrey, our nation's foremost authorities on federal tax law, and together they called for a substantial transformation of existing mechanisms for settling tax disputes. At that crucial time in history, high marginal tax rates intensified the friction between taxpayers and the government, boosted litigation and multiplied the number of tax controversies. Traynor and Surrey developed the idea of "preventive tax policy" aimed at preventing controversies from arising, and where they cannot be prevented, reducing the area in which they occur. This paper explores the joint project of these extraordinary men in its historical context and its implementation in Justice Traynor's understanding of tax adjudication. Their proposal serves as proxy for the evolution of tax avoidance in a time when tax acts became complex followed by frequent tax revisions enacted in response to tax evasion. It offers valuable guidance for reducing the complexity and vagueness inherent in our tax system, and for improving the relationship between taxpayers and government. Some of today's most important mechanisms to prevent tax avoidance originated in Traynor & Surrey's proposal, such as private letter ruling and advanced pricing agreements. Their proposition for a single court of tax appeals continues to be deliberated.

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I. INTRODUCTION

Roger J. Traynor was appointed to the Supreme Court of California in 1940 and served as its Chief Justice from 1964 to 1970. He is best known today for his judicial innovations in the fields of conflict of laws, product liability, and civil procedure.[1] His decisions on miscegenation, divorce, police searches and product liability were ahead of his time, and led California's legal system into the future. His most significant opinions included rejecting the legal prohibition of inter-racial marriages, adopting a no-fault divorce, restricting police searches and applying a strict standard of liability in product defect cases.[2]

However, few would trace Roger J. Traynor's roots to the field of tax law, where he developed, through academic, administrative, and judicial service, valuable principles that still prevail today. At the University of California, Berkeley, Traynor discovered his passion for tax law, and inspired his students to take this path in their professional careers. As an administrator, Traynor served California's tax system tremendously by shaping some of today's most important local tax acts, which were adopted by other states and countries. Later on, Traynor became an expert consultant to the Treasury and participated in drafting major federal tax legislation. As a Supreme Court judge, Traynor wrote decisions in the field of taxation that remain good law, and provide guidance for complicated issues including, for example, computing estate tax marital deductions, and the earnings and profits of corporations. What is most unlikely, however, is that Traynor will partner with Stanley Surrey, our nation's foremost authorities on federal tax law, and the leading proponent of tax reform during his life.[3]

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1 Adrian A. Kragen, *In Memoriam: Roger J. Traynor: Chief Justice Traynor and the Law of Taxation*, 5 HASTINGS L.J. 801, 802 (1984).

2 BEN FIELD, ACTIVISM IN PURSUIT OF THE PUBLIC INTEREST: THE JURISPRUDENCE OF CHIEF JUSTICE ROGER J. TRAYNOR, xiv (2003).

3 The Townsend Harris Medal at: http://www.ccny.cuny.edu/townsend_harris/awards/s_z.htm

As Harvard law dean and tax professor once said, Stanley S. Surrey was the ultimate tax professor and a *"True Public Servant"*.[4] In 1933 he joined the New Deal administration and established himself as a highly ranked legal counsel at the Treasury Department.[5] In 1951, he joined the Harvard Law School faculty, where he remained an active member for thirty years[6] while continuing to serve as a consultant to the United States government and as an advisor at the United Nations on international tax projects[7]. However, his best known and most important work was formulating the tax expenditure concept. As assistant secretary for tax policy in the Treasury Department, Surrey promoted the legislation establishing today's tax expenditures section of the government's budget, which enumerates incentives and subsidies granted through the tax system, thus emphasizing their oversized component of the income tax system. His aim was to raise public awareness to the extent to which government

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4 Erwin N. Griswold, *In Memoriam: Stanley S. Surrey*, 98 HARV. L. REV. 329, 331 (1984).

5 Surrey worked in the National Recovery Administration in Washington from 1933 to 1935 and at the National Labor Relations Board from 1935 to 1937. In those positions, Surrey found a meaningful outlet to improving government policies. On the influence of the New Deal on Surrey from his brother, *see* Walter Sterling Surrey, STANLEY S. SURREY 1910-1984, HARVARD UNIVERSITY (1984), A MEMORIAL SERVICE HELD OCT. 3, 1984 AT MEMORIAL CHURCH, HARVARD UNIVERSITY.

6 In Harvard, even as professor emeritus, Surrey continued to participate in many projects, such as the Income Tax Project of the American Law Institute. He organized the International Program in Taxation at Harvard, produced the World Tax Series, and published various tax books and articles. He was the president of the National Tax Association in 1979-1980 and through it published major tax articles. Surrey wrote 20 books and 97 articles, not including legislative records. James Vorenberg, STANLEY S. SURREY 1910-1984, HARVARD UNIVERSITY (1984), MEMORIAL SERVICE HELD OCT. 3, 1984 AT MEMORIAL CHURCH, HARVARD UNIVERSITY.

7 Surrey's contribution to the development of international tax systems was vast. He was instrumental in formulating tax treaties between developed and developing countries, and in developing the new tax system that evolved after World War II. For example, he was responsible for the adoption of Resolution A.3 adopted at the conference of Punta del Este in 1961 by which member governments of the Organization of American States explicitly endorsed a program to reinforce tax systems. The Resolution was adopted by The Pan American Union, the Economic Commission for Latin America and the Inter-American Union, Economic Commission for Latin America and the Inter-American Development Bank, in cooperation with the Harvard University Law School International Program of Taxation in August 1961. Milton Katz, STANLEY S. SURREY 1910-1984, HARVARD UNIVERSITY (1984), A MEMORIAL SERVICE HELD OCT. 3, 1984 AT MEMORIAL CHURCH, HARVARD UNIVERSITY. Between 1949 and 1950, Surrey participated in planning and developing a new tax system for Japan, as a member of the American tax mission to Japan. Surrey reported his mission was most importantly to devise a simple and progressive system, which was later acclaimed to bring Japan a "dazzled economic performance and rapid growth since World War II." Erwin N. Griswold, *In Memoriam: Stanley S. Surrey*, 98 HARV. L. REV. 329, 331 (1984). In 1960, he joined his Harvard colleague Oliver Oldman in a research project on the tax system of Argentina for the government of Argentina through the auspices of the Ford Foundation. Report of a Preliminary Survey of The Tax System of Argentina; Prepared for the Government of Argentina through the auspices of the Ford Foundation by Stanley S. Surrey and Oliver Oldman (Cambridge, Mass., Harvard Law School, 1960).

subsidizes certain activities through the tax code. After his retirement, Surrey continued to update and publish volumes of his famous textbooks on taxation, such as "Federal Income Taxation--Cases and Materials" and "Federal Wealth Transfer Taxation--Cases and Materials," books that are known to every law student as the building blocks of tax education.

Little is known about the strong bond between Traynor and Surrey, who both commenced their careers in the tax law field, and have had an enduring impact on the American tax system. Traynor collaborated with Surrey during President Roosevelt's second term, towards the end of the Great Depression, when the top marginal tax rate climbed back to its World War I-era maximum of 78 percent.[8] The high marginal tax rates intensified the friction between taxpayers and the government, boosted litigation and multiplied the number of tax disputes.

At this crucial juncture in the late 1930s, Traynor and Surrey called for a substantial transformation of existing mechanisms for settling tax disputes. During these years, an overload of tax litigation had created inequities that increased the public's discomfort with the tax system. The Bureau of Internal Revenue failed to operate under the burden of individual and corporate tax disputes. When Congress established the Board in 1926, it considered the board a technical tax expert tribunal within the executive branch, designed to serve as a professional mediator between taxpayers and the tax commissioner, rather than to function as a court. However, the absence of filing fees prompted taxpayers to take their disputes to the Board. Traynor and Surrey demonstrated that on average, it took the Board three years to issue a decision. Most of the cases involved a relatively small dollar amount

[8] In 1918 the top marginal tax rate was 78 percent, and between 1919 and 1921 it was 73 percent. In the post World War I period the maximum rates declined gradually and their lowest level was 24 percent in 1929. During the Depression period that followed the stock market crash, the top marginal tax rate increased rapidly to 79 percent in 1936 and continued this trend in the Second World War to a top of 94 percent in 1945.

and a focus on questions of fact, which for the most part could have been resolved more quickly, and at lower expense, by an administrative body.[9]

Traynor and Surrey criticized this inefficient system of adjudication and proposed ways to minimize litigation through what they called a "preventive" tax policy "designed to prevent controversies from arising," and where they cannot be prevented "to reduce the area in which they occur."[10] Their idea of preventive tax policy entailed reducing the complexity of the tax code and improving the administrative resolution of tax cases, thereby minimizing disputes over tax matters. They called for more flexibility of the tax system by decentralizing the administrative and judicial systems. The two contended that the dispute resolution process had lost its effectiveness and clarity due to complexity added by judicial interpretation. "Too much law,"[11] they said, caused taxpayers to seek out expensive legal advice in order to "thread their way through the complicated maze of tax law."[12] Another aspect of Traynor and Surrey's proposal was to limit appellate reviews and institute a single court of tax appeals in various locations.

Ultimately, Traynor continued to the judicial bench and became Chief Justice of the Supreme Court of California, while Surrey blossomed in Harvard's academy and the executive branch as Assistant Legislative Counsel to the United States Treasury. However, when they proposed their preventive tax policy, they were both Treasury consultants. This paper will explore the joint project of these extraordinary men in its historical context and its implementation in Roger Traynor's understanding of tax adjudication. Through legal-

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9 Roger J. Traynor, *Administrative and Judicial Procedure for Federal Income, Estate, and Gift Taxes- a Criticism and a Proposal*, 38 COLUM. L. REV. 1394 (1937).

10 Roger J. Traynor & Stanley S. Surrey, *New Roads Toward the Settlement of Federal Income, Estate, and Gift Tax Controversies*, 7 LAW & CONTEMP. PROBS. 336, 352 (1940).

11 Roger J. Traynor & Stanley S. Surrey, *New Roads Toward the Settlement of Federal Income, Estate, and Gift Tax Controversies*, 7 LAW & CONTEMP. PROBS. 336, 351 (1940). This exact phrase was also used by Justice Robert H. Jackson. He claimed that the elaborate tax system was "too much law, and too many kinds of law, and from too many sources, for tax administration to be simple, or the law clear." Kirk Stark, *The Unfulfilled Tax Legacy of Justice Robert H. Jackson,* 54 TAX L. REV. 171, supra 97 at 187 (2001).

12 Roger J. Traynor & Stanley S. Surrey, *New Roads Toward the Settlement of Federal Income, Estate, and Gift Tax Controversies*, 7 LAW & CONTEMP. PROBS. 336, 351 (1940).

historical analysis, the paper also examines the taxpayer-government relationship in view of changes in politics, economics, and culture in the interwar years.

As the tax policy community continues to debate questions concerning the scope and nature of tax law, and the role of the administration and judiciary in its development, it is important to study the objectives of the individuals who helped to shape it. Traynor and Surrey's idea of a preventive tax policy was instrumental in shaping our tax system. Their idea of a closing agreement for a future transaction, known today as a private letter ruling, originated as a result of their proposal. Their proposition for a single court of tax appeals continues to be deliberated. Their proposal can serve today as valuable guidance for reducing the complexity and vagueness inherent in our tax system, and for improving the relationship between taxpayers and the government.

Following this brief introduction, parts II and III provide a historical overview of the development of the tax system between 1913 and 1940 and detail the administrative and judicial problems at that time, as a background for Traynor and Surrey's work. Part IV tells the story of Traynor's tax education and how he met Surrey, along with an outline of their proposal to improve the interwar tax system. Part V describes the success of implementing preventive tax policy in the U.S. tax system, specifically in Traynor's decisions. Finally, Part VI summarizes the importance of preventive tax policy at a turning point in history and their effect on today's tax system.

II. THE INCOME TAX SYSTEM IN THE INTERWAR PERIOD

Taxing the income of individuals in the United States began during the Civil War, and appeared inconsistently in various forms until it was constitutionalized in 1913. That year, the remaining three states ratified the Sixteenth Amendment, which authorized Congress to impose taxes on income without apportionment by population and created a new and

permanent statutory reality. The first income tax bill was modest, imposing graduated rates with a maximum rate of seven percent and large exemptions.[13] The campaign for the income tax was mainly led by states, which struggled to raise revenue and endured heavy federal tariffs and excise taxes.[14] Those states' representatives argued for an income tax by emphasizing that it would be a progressive tax; that is, it would tax people according to their ability to pay. However, while progressive ideas of redistributing wealth and equality were part of the public debate, congressional debates focused on the income tax as a suitable device to raise the revenue necessary anticipated for the forthcoming war.

Until 1916, moderate tax rates and large exemptions resulted in little added revenue for the Treasury and the new income tax remained a marginal source of income for the federal government. Excise taxes and tariffs accounted for 90 percent of federal government receipts, thus the new income tax affected few people. However, the U.S. decision to enter World War I in April 1917 resulted in higher defense expenses, and the government turned to the income tax knowing it would generate immediate revenue needed to fund defense costs.

The collective political agreement in Congress to enter the war also reflected the unified political atmosphere of the period and bipartisan support for increasing the income tax burden. For the first time, American armies were sent to fight on European soil. The public mood seemed to be that it was the patriotic duty of the homeland to make financial sacrifices to support the troops at the battlefront. In 1916, income and corporate taxes accounted for 16 percent of government revenue; by 1920 the figure had grown to 58.6 percent. In just a few short years the maximum individual tax rate reached 77 percent. The government raised $13.5 billion between 1917 and 1920, primarily from progressive taxes on individual incomes and corporate profits, as it reduced its heavy reliance on import duties.[15]

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13 Revenue Act of 1913, ch. 16, II.B, 38 Stat. 166-167 (1913).

14 ELLIOT W. BROWNLEE, FEDERAL TAXATION IN AMERICA: A SHORT STORY 40-45 (Woodrow Wilson Center Press 1996).

15 *Id.* at 44.

Scholar John F. Witte aptly summed up the atmosphere of the period when he said, "the need for revenue ruled the discussion over progressive arguments."[16]

Once the war was over and the government had paid for much of those costs, there was a general desire for isolationism and steady healing.[17] Revisions to the income tax rate were no exception, and the Republicans who regained power in the 1920s called for a "return to tax normalcy."[18] The maximum individual tax rate dropped from 77 percent in 1918 to 24 percent in 1929. Attempts to increase the tax burden on individuals and corporations under the axiom of taxing accumulation of wealth encountered heavy resistance in Congress.[19] At that time, debates on tax policy issues crossed party lines and created voting "abnormalities" when Congress discussed new tax legislation.[20]

From then on, tax policy became a major issue in public and political discourse. Tax legislation became more frequent, contributing to the development of the tax code as well as the growing complexity of the tax system. For example, taxation of businesses varied according to the size of the entity and the nature of the organization. Special deductions, credits, and other provisions made the tax code denser. Taxes on individuals varied depending on the amount of their income, their type of income, and the source of their income. At the same time, politicians and scholars began to criticize the complexity of the tax code.[21] Writing about how the 1935 revenue act was enacted, Treasury official Randolph

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16 JOHN F. WITTE, THE POLITICS AND DEVELOPMENT OF THE FEDERAL INCOME TAX 83 (1985).

17 President Harding recorded several speeches to the nation calling for a return to normalcy: "America's present need is not heroics but healing; not nostrums but normalcy; not revolution but restoration...not surgery but serenity." *Readjustment*, Warren G. Harding speech on May 14th, 1920. The audio playback of this speech is available at: http://lcweb2.loc.gov/ammem/index.html

18 WITTE, at 89.

19 Roosevelt's campaign for "soak the rich" legislation encountered a hesitant Senate that was not ready to accept a completely new tax on such short notice. *Id.* at 101.

20 Such abnormalities were seen as Roosevelt's initiatives encountered opposition from members from his own Democratic party.

21 A movement for tax simplification led by T.S. Adams, a Yale economist, criticized the tax bills for being too complex and suggested that the future implications of this complexity would be beyond patching. WITTE, *Supra* note 7 at 91.

Paul commented, "It is doubtful whether more than a handful of those who remained on the floor understood the complicated 236 page measure."[22]

The role of the Treasury administration in shaping tax policy increased during this period. The administration's role shifted from simply calculating the revenues and expenditures needed for war finance, to planning ways to accomplish budgetary goals. Treasury officials took on a major role in the politics of taxation. They initiated revenue legislation and participated in formulating revenue acts in tax committees.

In the late 1930s, the legislative process reflected constant compromise between the administration, which typically sought expansion of the government, and Congress, which was dominated by representatives from the south who generally opposed this propensity. The Great Depression was a decade of unemployment and stagnancy. President Franklin D. Roosevelt's New Deal plan of relief and social development programs between 1933 and 1938 involved substantial expansion of the administration, and a natural need to raise more revenue. As a result, the maximum tax rates increased to 63 percent in 1933 and reached 79 percent in 1936. As tax rates increased, the stakes became higher, escalating the friction between taxpayers and the government. This led to higher rates of tax evasion and multiplied the number of tax disputes between individuals and the government. The growing number of tax disputes underscored the need for reform of administrative and judicial settlement procedures.

Several incidents in the late 1930s involving senators and governmental officials exacerbated concerns about tax evasion.[23] Roosevelt responded by campaigning for taxation

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[22] WITTE, *Supra* note 26 at 102.

[23] The most famous case was the Republican Treasury Secretary Andrew Mellon. This case symbolized the political struggle between the New Deal administration and Republicans. Mellon was considered one of America's richest men, and he was responsible for tax policy and tax administration by virtue of his duty as Secretary of Treasury. Senator James Couzens accused Mellon of corruption, illegal favorable treatment of tax relief, tax benefits granted to Mellon's companies by the Bureau, and of reducing his income tax return by creating artificial losses. For a detailed description of this case from the government's perspective, *see* Stark, at 189. *See also* W. ELLIOT BROWNLEE, FEDERAL TAXATION IN AMERICA: A SHORT STORY 44 (Woodrow Wilson Center Press 1996); Assaf Likhovski, *The Story of*

of accumulated wealth; Congress instead adopted a slow and conservative approach. Revenue acts were enacted almost every year in an attempt to close new loopholes and halt the exploitation of tax laws by wealthy individuals and corporations. Reports published in 1936 described rich individuals sheltering money in foreign holding corporations, and incorporating their private yachts to escape taxation.[24] In a bipartisan move, the government established a special Joint Committee on Tax Evasion and Avoidance. Within weeks, the Committee produced a report on common evasion techniques used by the 67 wealthiest families in the United States.[25] The report generated intense public reaction, and Congress responded by unanimously passing a bill applying strict limitations on personal holding companies.[26]

It was clear at that time that compliance levels had declined, and the relationship between taxpayers and the government had deteriorated. This spurred a shift in tax legislation: Whereas previously officials had cited a need to raise revenue or a desire to make the tax system more progressive, the tax acts of the late 1930s marked the beginning of complex and frequent tax revisions enacted in response to tax evasion. As a result, taxpayers increasingly sought advice from tax lawyers, and the courts were faced with a high volume of tax disputes.

Gregory: How are Tax Avoidance Cases Decided?, in STEVEN A. BANK & KIRK J. STARK, BUSINESS TAX STORIES, 123 (2005).

24 *Tax Evasion,* N. Y. Times May 29, 1937. Franklin D. Roosevelt, *Text of Roosevelts Tax Evasion Message,* L.A. Times, Jun 2, 1937. In his 1936 reelection speech, Roosevelt stormed against what he called "economic royalists," meaning rich tax evaders who used family trusts, pension plans, and family partnerships to avoid high surtaxes and estate taxes. It so happened that Eleanor Roosevelt was also suspected of tax avoidance activity by transferring money received for her radio performances.

25 Report of the Joint Comm. on Tax Evasion and Avoidance of the Congress of the United States, H.R. Doc. No. 75-337 (1937).

26 The new bill contained adjustments to the revenue act concerning personal holding companies. This was the second bill passed addressing personal holding corporations; the revenue act of 1934 defined them as any corporation if 80% or more of the corporation's income was derived from certain passive-type income, and more than 50% of the stock was owned by five or fewer individuals. (Revenue Act of 1934, ch. 277, § 351, 48 Stat. 680, 751) Nevertheless, tax attorneys abused this act and developed sophisticated legal methods to avoid entering into that definition and in 1937 the definition of "personal holding corporation" was altered. Revenue Act of 1937, Pub. L. No. 75-377, § 337, 50 Stat. 813 (1937)

In conclusion, the income tax underwent a major transformation from the period of its adoption in 1913 to the eve of World War II. Although it began as a "class tax" and a marginal source of revenue, it became a mass tax with highly progressive rate structure.[27] From a top rate of 7 percent in 1913, income was taxed at maximum of 81 percent in 1940. The income tax developed into a major source of revenue to fund government expansion and war expenses. Tax compliance also changed dramatically throughout this period; higher tax rates led to higher tax evasion. Complex tax laws and the cost of complying with those laws became a major concern of the government and the tax administration. In this climate, Traynor acted to improve the interwar tax system. The next section will examine how incoherent fiscal practices as well as inefficient institutional structures overloaded the interwar tax system and created substantial delays in resolving disputes. Those delays weakened the efficiency of the tax system, created uncertainties and confusion, and threatened the Treasury's ability to raise the necessary revenue.

III. INCOHERENT FISCAL PRACTICES AND TOO MUCH LAW

A. Breakdown of Judicial Tax Review

A first attempt by the Treasury to reduce tax disputes came with the establishment of the Board of Tax Appeals ("Board") in 1924 as an independent agency within the executive branch of the government.[28] Theodore Tannenwald described the circumstances surrounding the decision to establish the Board as a period of general public discomfort with the Bureau of Internal Revenue, which experienced difficulties coping with administrative problems

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[27] In the twenties and thirties, the tax burden fell mainly on the elite and on the corporations, which at the time were criticized for accumulating wealth on the back of the nation, especially the ammunition industry profiting from World War I.

[28] Revenue Act of 1924, Pub. L. No. 68-176 §900, 43 Stat. 336 (1924).

produced by the relatively new broad-based income and profits tax.[29] Centralized in Washington, the Board was composed of seven members who were tax experts appointed by the president. It had parallel jurisdiction with the District Courts and the Court of Claims in suits for refund and it was subject to appellate review by the Circuit Courts of Appeal.

Among the Board's weaknesses was the fact that taxpayers could choose from three courts that possessed original jurisdiction over tax cases,[30] which led to forum shopping. Many taxpayers opted for the Board of Tax Appeals because as opposed to other jurisdictions it did not require prepayment of tax liability. While the Board maintained original jurisdiction only over tax matters that originated from a deficiency letter issued by the tax commissioner, it lacked authority over refund claims or any overpayment cases.[31]

Moreover, although the Board of Tax Appeals was based in Washington D.C., it had jurisdiction throughout the United States.[32] The Board traveled to all parts of the country, and appeared in each location once a year. Therefore, it had to accumulate enough cases to justify visiting a certain location, which created huge delays and serious overload.[33] In 1938, the Board could handle only 20 to 25 percent of the petitions filed. It was only a matter of time until the Board would fail to function under the sheer volume of the incoming petitions.

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29 Theodore Tannenwald, Jr., *The United States Tax Court: Yesterday, Today and Tomorrow: Erwin N. Griswold Lecture before the Annual Meeting of the American College of Tax Counsel, San Antonio, Texas, January 23, 1998,* 15 Am. J. Tax Pol'c 1, 4 (1998).

30 The taxpayer had the liberty to file a refund claim through the District Court or the Court of Claims, or a petition with the Board of Tax Appeals.

31 This limited jurisdiction originated prior to the establishment of the Board, when the Federal District Courts and the Court of Claims had the authority to adjudicate recovery of paid taxes and claims for refunds.

32 A study in 1934 showed that over 90 percent of the Board cases were outside of Washington; seven states accounted for 59.5 percent of the cases, another seven states accounted for 16.9 percent, and the remaining 23 percent accounted for 34 other states, which emphasized the geographical spread of tax disputes before the Board. Roger J. Traynor, *Administrative and Judicial Procedure for Federal Income, estate, and Gift Taxes- a Criticism and A Proposal,* 38 COLUM. L. REV. 1394, 1405 (1938).

33 In fiscal year 1937-1938 the percentage of cases closed by Board decision after trial was only 19.1 percent (1,108 cases out of 5,799). At the close of fiscal year 1938-1939 there were 7,864 pending tax cases involving $456,974,846. By the end of fiscal year 1938-1939, there were 6,574 cases before the Board of Tax Appeals. Roger J. Traynor & Stanley S. Surrey, *New Roads Toward the Settlement of Federal Income, Estate, and Gift Tax Controversies*, 7 LAW & CONTEMP. PROBS. 336, 338 (1940).

A little more than a decade from its establishment and while "still very much in the process of earning its reputation,"[34] the Board of Tax Appeals struggled to operate under the heavy load of cases: 90.3 percent of cases closed in 1934 involved tax years prior to 1931; 66.3 percent involved tax years prior to 1930; and 37.3 percent involved tax years prior to 1929.[35] No doubt the heavy load of cases was directly related to the ease of filing a petition with the Board. While waiting for a Board hearing, about 70% of the cases were closed by settlement with the administration. However, nearly 5,000 new petitions were filed annually, leaving a large accumulation of cases for the year to come. The great majority of the petitions involved only small dollar amounts or concerned factual questions, both of which could have been settled more efficiently and inexpensively between the taxpayer and the administration. There was no efficient mechanism in place to solve these cases that did not require judicial review.[36]

B. Delays and Lack of Information

Soon after the income tax was established, taxpayers realized they could deliberately delay paying their tax obligation by filing a claim with the Board of Tax Appeals. The interwar tax system did not make a clear distinction between judicial and administrative review of a case. Filing a petition with the Board should have marked the end of administrative review and the beginning of judicial consideration, but in fact, cases remained in the administration for at least two more years for further review by various Bureau officers.

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34 Stark, at 195.

35 Roger J. Traynor, *Administrative and Judicial Procedure for Federal Income, estate, and Gift Taxes- a Criticism and A Proposal,* 38 COLUM. L. REV. 1393, 1394 (1938).

36 By the end of fiscal year 1938-1939 over 56 percent of the petitions filed with the Board involved amounts of less than $5,000 and over 38 percent involved amounts of less than $2,000. Roger J. Traynor & Stanley S. Surrey, *New Roads Toward the Settlement of Federal Income, Estate, and Gift Tax Controversies,* 7 LAW & CONTEMP. PROBS. 336, 339 (1940).

Although the majority of tax-dispute cases did not require judicial resolution and neither the taxpayer nor the government officials believed judicial review was necessary, delays in administrative settlement became a negotiation tool for the parties. While Bureau officials had a common goal of settling the case administratively to rapidly recover unpaid tax liabilities, in reality, cases were pushed from one level to the next without being resolved. Initially, Bureau of Internal Revenue field office agents handled tax disputes. If not resolved, the case was then transferred to the Conference Division, the Technical Staff and if necessary, reviewed by the Office of Chief Counsel. If not resolved by then, the Appeals Division at the Bureau brought the case to the judicial level. At each stage, Bureau officials had the authority to settle the tax dispute, whether in the administrative or judicial stage. Of the cases that ended with an agreement, about one-third were settled at the Technical Staff level and two thirds by the Appeals Division.[37]

While Bureau agents often offered to settle cases, many were reluctant to take responsibility to truly dispose of a case, knowing they could shift that responsibility to various other officers in the Bureau. This gave taxpayers multiple settlement opportunities and encouraged them to litigate.[38] Taxpayers could make one argument contesting their liability when they applied to the Board, then after multiple stages of review by field agents and other officials in the bureaucracy, they could assess which settlement offer was the best bargain. Therefore, by paying ten dollars, a taxpayer who failed to pay his taxes or settle his case with the administration could defer his tax liability by entering the long trial line – even if he had not fully exhausted other settlement mechanisms.

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[37] Roger J. Traynor & Stanley S. Surrey, *New Roads Toward the Settlement of Federal Income, Estate, and Gift Tax Controversies*, 7 LAW & CONTEMP. PROBS. 336 (1940).

[38] Roger J. Traynor, *Administrative and Judicial Procedure for Federal Income, Estate, and Gift Taxes- a Criticism and a Proposal,* 38 COLUM. L. REV. 1393, 1399 (1938). Theodore Tannenwald, Jr., *The United States Tax Court: Yesterday, Today and Tomorrow: Erwin N. Griswold Lecture before the Annual Meeting of the American College of Tax Counsel, San Antonio, Texas, January 23 1998,* 15 Am. J. Tax Pol'c 1, 4 (1998). Theodore Tennenwald, *The Tax Litigation Process: Where It Is and Where It Is Going*, 44 REC. ASS'N B. CITY OF N.Y. 825, 827 (1989).

When finally the parties attended their long-awaited Board hearing, often they were surprised to learn about new issues not mentioned in the initial deficiency letter. Taxpayers' inability to provide complete details in the petition to the Board and the failure of the Bureau to demand full disclosure of the facts, created further delays in the judicial branch, which now had to waste time compiling the necessary information. Had the administration had the facts of the case beforehand, some cases would not have been disputed at all. Since neither the taxpayer nor the commissioner could comprehend the correct legal treatment from the meager facts stated in the deficiencies, it exposed the government-taxpayer relationship to unnecessary costs. At this point, the taxpayer had already sought professional advice, the Bureau had performed an investigation of the case, and the judicial branch had to waste valuable time on a factual investigation instead of judicial review of important legal matters. This chain of events originated from the failure to obtain complete and accurate information from taxpayers before the Board hearing and could have been avoided.

The constant delays in resolving tax disputes impaired tax collection, increased the likelihood of taxpayer default, and resulted in a substantial revenue loss for the government. Since years could pass between the filing date of a dispute and the final resolution, the taxpayer often could be in a different financial state, sometimes even insolvent. Taxpayers were not required to provide any type of security when filing a petition with the Board. Consequently, in some cases, following long litigation the issue became merely a theoretical matter, due to the taxpayer's inability to pay the final judgment. In those days the government lost substantial amounts of revenue due to those delays during which the taxpayer became unable to meet his full tax liability.[39]

[39] In fiscal year 1936-1937 over 11 percent, amounting to $1,745,203, of the total amount assessed after hearing Board decisions proved uncollectible. In fiscal year 1937-1938 jeopardy assessments totaling $45,867,553 in taxes, interest, and penalties were made in respect to 2,327 income tax returns. Roger J. Traynor, *Administrative and Judicial Procedure for Federal Income, Estate, and Gift Taxes- a Criticism and a Proposal,* 38 COLUM. L. REV. 1393, 1397 (1938).

C. Complexity and Uncertainties

The interwar tax system also produced high levels of confusion and uncertainty. Typically, six years passed between the date of the return and the decision of the Board of Tax Appeals. As a rule, a case spent its first three years in the Bureau of Internal Revenue and its last three years in the Board of Tax Appeals. However, the tax dispute was not over yet; many cases continued appellate litigation in the Circuit Courts for another two years, while others made it to the Supreme Court for another year. That meant it could take up to nine years for a tax dispute to finally be settled. In the meantime, both the taxpayer and the government remained uncertain of the tax consequences.[40]

Further complicating matters was the fact that the Board's decision-making lagged behind the legislative code. For example, when Congress solved problems from previous tax acts and enacted the revenue act of 1939, the judiciary was still interpreting the revenue acts of 1932 and 1934.[41] Before his appointment to United States Supreme Court and while serving as general counsel at the Bureau, Traynor's friend and supporter Justice Robert H. Jackson criticized the interwar tax system, stating: "Some of the complexity, conflict and confusion in the tax law is due to the number of cooks who make the broth..."[42] While testifying before the Joint Committee on Tax Evasion and Avoidance, Jackson claimed, "Many cases resulting in long periods of confusion and uncertainty in large litigation, and many unfair results could be cited in which the delay in learning what law the Court would apply has been responsible."[43] Appearing in front of Bureau tax lawyers, Jackson noted, "You might be shocked to know that we [Bureau representatives] sometimes… take opposite sides

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40 Roger J. Traynor, *Administrative and Judicial Procedure for Federal Income, Estate, and Gift Taxes- a Criticism and a Proposal*, 38 COLUM. L. REV. 1394 (1937).

41 *Id.* at 1398.

42 Robert H. Jackson, *Equity in the Administration of Federal Taxes*, 13 TAXES 641, 643 (1935).

43 *Id.* at 644.

of the same question, whichever will be to the advantage of the revenues. I was shocked at the apparent dishonesty of that policy."[44]

An example of the uncertainty generated by the administration can be found in the *Hendler* case.[45] The legal question raised in this case was whether assumption of a liability by a transferee corporation under general tax-free "plan of reorganization" exchanges is taxable property. Until 1938, such transactions were exempt from tax. However, in 1938 the Supreme Court held in *Handler* that the assumption of liability is "property" taxable to the corporate transferee. Nonetheless, what the government did not realize until it was too late was that while it had won this case, it was going to lose tremendous revenue because of the new "stepped-up basis" rule created by the court, by which the transferee's basis of the transferred property was increased by the gain recognized by the transferor. The whole structure of the reorganization tax treatment was at risk of becoming a tax avoidance tool by creating stepped-up basis in tax-free reorganizations. This unfortunate episode ended when Congress retroactively amended the statute to provide that assumption of liability does not constitute boot in a tax-free exchange. [46]

Another example of the confusion inherent in the system was the inverted pyramid of multiple appellate reviews that produced opposite opinions in similar federal tax matters. Taxpayers filing a tax claim could choose among the Board of Tax Appeals, the District

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44 Stark, at 185. When discussing Justice Jackson's insights on the federal tax litigation from his position as a career government lawyer, Stark described the problems of the interwar tax adjudication: "[Jackson] focused on the delay and uncertainty associated with lengthy appellate consideration of disputed tax issues. Disputed legal issues often festered unresolved for several years, perhaps even decades, before the Supreme Court offered its "final" resolution. And not uncommonly… Congress promptly amended the statute to reverse the Court's decision. Such extended litigation, in combination with aggressively self-interested reporting positions and limitations concerning prior taxable years, produced unfairness and complexity in the administration of the law." Stark at 207 and *supra* note 85 at 185.

45 United States v. Hendler, 303 U.S. 564 (1938).

46 For a thorough discussion of the *Hendler* story *see* Stanley S. Surrey, *Assumption of Indebtedness in Tax-Free Exchanges*, 50 YALE L.J. 1 (1940).

Courts, and the Court of Claims.[47] While the Board was the most popular choice, the other tribunals had equal precedent power and were subject to an appellate review by 11 Circuit Courts that sometimes issued contradictory decisions, causing vagueness until the Supreme Court settled the matter (if at all). Taxpayers and their counsels used this lack of uniformity in devising tax schemes. They reviewed the latest decisions in each tribunal, and chose to litigate in a specific tribunal if they thought it would rule in their favor. The Bureau was not free from those considerations, and there were situations in which the main reason for its assertion of a deficiency was to foster a circuit split.[48]

In short, the historical evidence shows that the U.S. system for resolving tax disputes in the interwar period failed its purpose. Taxpayers could defer their tax liability by simply looking for a glitch or ambiguity they could use as a basis for filing a tax dispute. As a result, the Commissioner was forced either to litigate or to settle to prevent delays or an unfavorable precedent. Duplicate appellate reviews of the Board's decisions created uncertainties, and an incentive for taxpayers to "try their luck" in litigating. A dispute that went as far as the Supreme Court could take nearly a decade to be resolved, by which time Congress may have amended the statues to provide for a different tax treatment. With those problems in mind, Traynor partnered with Surrey and prepared a comprehensive reform proposal. Its principles are described in the next section. However, in order to understand Traynor's influence in the field of taxation, first we have to understand how he came to the study of tax law and to collaborate with Surrey. An outline of Traynor's life story and his acquaintance with Surrey will be presented, followed by a detailed discussion of their idea of preventive tax policy.

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47 For similar criticism of the interwar tax system *see* Theodore Tennenwald, *The Tax Litigation Process: Where It Is and Where It Is Going*, 44 REC. ASS'N B. CITY OF N.Y. 825, 827 (1989).

48 Stark, at 200.

IV. PREVENTIVE TAX POLICY

A. Traynor's Tax Education and His Encounter with Stanley Surrey

"There is no sounder currency in the courts across the country than a Traynor opinion."[49]

Roger J. Traynor was born on February 12, 1900, the son of Irish immigrants who settled in the small town of Park City, Utah.[50] He received both his PhD in political science and J.D. in the spring of 1927.[51] While studying law, Traynor discovered his passion for tax law, and soon thereafter, he received an appointment as a tax law professor at Boalt Hall law faculty. Traynor taught a course called "Principles of Income and Inheritance Taxation," using a unique method of combining "dry law" with complex tax policy and jurisprudence considerations, exposing students to both the practical and philosophical aspects of taxation. His influence over his students encouraged many of them to pursue careers in the field of taxation.[52]

As a man of many interests, Traynor enjoyed putting his practical knowledge of tax law to use in the public service. In 1932, Traynor advised the California State Board of Equalization on devising methods of local taxation to raise additional revenue. He helped in drafting the retail sales tax, the use tax, the Bank and Corporation Franchise Tax Act and the Personal Income Tax Act of 1935. Those state taxes survived battles challenging their constitutionality, and served as models in many states and countries as central sources of local revenue. In 1937, while Traynor was a tax counsel to California's Board of

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49 Walter V. Schaefer, *A Judge's Judge*, 71 CALIF. L. REV. 1050, 1051 (1983).

50 He nostalgically described his small-town life as like being in a melting pot that accommodated immigrants from all over the world, enriched by noble teachers who inspired him to choose the academic path. Traynor loved this environment of provincialism, "land of Bohunks and Micks and Krauts and Cousin Jacks" surrounded by mountain landscape, which he later compared to the path of a judge. Elizabeth Roth, *The Two Voices of Roger Traynor,* 27 AM. J. LEGAL HIST. 269, 288 (1963).

51 His academic life began in 1919, when Traynor received a scholarship for undergraduate studies at the University of California, Berkeley, and continued his graduate studies for a PhD in philosophy in the political science department. Inspired by Thomas Reed Powell, his constitutional law professor, Traynor decided to pursue a law degree while working on his dissertation and teaching in the political science department.

52 Adrian A. Kragen, *In Memoriam: Roger J. Traynor: Chief Justice Traynor and the Law of Taxation*, 5 HASTINGS L.J. 801, 802 (1984).

Equalization, he was appointed consulting expert in the federal Office of the Secretary of the Treasury.[53] Throughout his federal service, Traynor met Stanley Surrey and collaborated with him on ways to improve the tax administration system.

Traynor and Surrey worked together at the Treasury Department and at Berkeley, and shared a passion for tax law. In 1937, Traynor became a consultant to the Treasury and chose Surrey, then a young and eager tax professor and assistant legislative counsel at Treasury, as a reliable co-author and collaborator. One of their mutual projects was to review the effort to prevent taxpayers' misuse of the statute of limitations on deficiencies and refunds.[54] Their recommendations were incorporated in section 820 of the 1938 Revenue Act.[55]

The two continued to develop a critical analysis of contemporary tax problems. Their tax policy sought to balance the need to effectively collect revenue with the fundamental principal of taxation in accordance with the ability of taxpayers to pay. Their goal was to create what they called a "preventive tax policy," that is, tax policy aimed at both preventing tax disputes from arising and reaching the judicial system by improving the predictability, clarity and unity of the tax code (ex ante prevention), as well as producing a more effective administrative and judicial procedures for the swift resolution of those that do arise (ex post treatment).

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53 Since there were provisions of the Executive Order of 1873 prohibiting federal employees from holding office under any state, territorial or municipal government, President Roosevelt had to use his vested authority and sign a waiver to permit Roger Traynor to hold this position. Exec. Order No. 7708, 2 Fed. Reg. 2167, (Sept. 16, 1937).

54 Traynor collaborated with Professors John M. Maguire and Stanley S. Surrey and proposed a complete revision of the administrative provisions of the income tax system. The three professors wrote a series of articles explaining this reform and the remaining loopholes that need to be closed. John M. Maguire, Stanley S. Surrey & Roger J. Traynor, *Section 820 of the Revenue Act of 1938*, 48 YALE L. J. 509 (1939); Maguire, Stanley S. Surrey & Roger J. Traynor, *Section 820 of the Revenue Act of 1938*, 48 YALE L. J. 719 (1939).

55 Revenue Act of 1938, Pub. L. No. 75-554, § 820, 52 Stat. 447, 581-83.

B. Ex Ante Preventive Tax Policy

1. Precluding Initiation of Disputes

Traynor and Surrey thought it was essential for the tax system to have equilibrium between equality and complexity.[56] Such a balance, they said, is like "an arrangement of cargo for the holds of a ship if they are to equilibrate the incidence of a variety of taxes."[57] Much of the complexity of the tax system is designed to protect taxpayers by creating progressive tax rates, various tax deductions, and credits. Those measures serve to regulate and redistribute society's resources. Nevertheless, they believed, the tax system must also retain a sufficient level of simplicity.

As a first step toward avoiding tax disputes, the two urged making the tax code clearer. Complex regulations without proper guidelines or clarification force taxpayers to construe them at their peril. Predictability of the law is essential for society, they declared, as taxpayers who are overwhelmed by the scope of the law cannot act according to it. Moreover, as new circumstances arise over time, complicated tax rules create greater difficulties. Taxpayers seek confidence when planning their business and family affairs; any vagueness results in tax litigation.

2. Advancing the Administrative Disposition of Tax Disputes

The next step, Traynor and Surrey emphasized, is to improve the function of preliminary administrative negotiations between the taxpayer and the local revenue agent, since a great number of the deficiencies, particularly small cases, could have been disposed of that way. The two stressed the need for competent and fair handling of initial negotiations in

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[56] Roger J. Traynor & Stanley S. Surrey, *New Roads Toward the Settlement of Federal Income, Estate, and Gift Tax Controversies*, 7 LAW & CONTEMP. PROBS. 336 (1940). Justice Robert H. Jackson was one of the critics of the complexity of the interwar tax system. Nevertheless, he opposed to the notion that complexity might serve other important purposes, such as fairness. He criticized the "elaborate procedural apparatus as institutional overkill in the need of reform." Stark, at 187.

[57] Roger J. Traynor & Stanley S. Surrey, *New Roads Toward the Settlement of Federal Income, Estate, and Gift Tax Controversies*, 7 LAW & CONTEMP. PROBS. 336, 338 (1940).

order to provide the taxpayer with an informal, non-judicial and inexpensive opportunity to settle the matter. If necessary, a case of particular importance could be further clarified by a conference of tax experts at the Bureau of Internal Revenue, they suggested. The purpose of the conference would be to provide responsible examination of the issue and, at its conclusion, produce an official report. At the end of this process, the taxpayer would be confident the case had been thoroughly considered, and if necessary, both parties would be ready to defend their position in a judicial process.

If the matter was not settled in the conference, the commissioner would notify the taxpayer regarding the proposed deficiency, and the taxpayer could reply by filing a detailed protest to the commissioner. Traynor and Surrey suggested using the protest letter to demand taxpayers' full disclosure of the facts and provide a statement of all the transactions involved. Failure to file would result in a deficiency letter. The proposed protest should be in writing, they said, under oath, and it should contain all the information and documents relevant to the case. The two emphasized that the purpose of this statement was to clear all factual issues and to restrict any remaining controversy to legal questions. Furthermore, the highest-ranking experts in the bureau should review this statement, since they have the authority to correct the mistakes of their office and to prevent unnecessary litigation.

The proposed protest procedure would have shifted the burden of proof to the taxpayer; it would be the latter's responsibility to disclose information in his complete control. It aimed to eliminate the ineffectiveness of the existing mechanism, which at that point in time contained poor and inadequate information.[58] The proposed disclosure requirement cost nothing for the taxpayer, who had all the facts in his possession and was crucial to the determination of the matter. This proposal shifted the burden of proof toward

[58] In average, about 67.4 percent of the total amount of deficiencies, which the Commissioner was forced to abandon, reveal the difficulty of attempting to determine tax liabilities without full and accurate information. Roger J. Traynor, *Administrative and Judicial Procedure for Federal Income, Estate, and Gift Taxes- a Criticism and A Proposal,* 38 COLUM. L. REV. 1394, 1401 (1937).

the natural course of matters, to the party in control of the information, in accordance with the self-assessment principal by which a return is filed. By the end of the protest procedure, the commissioner issued a final deficiency notice, stating the specific finding, allowing the taxpayer to make a rational decision whether to pursue the matter to the Board of Tax Appeals. Further structure was imposed on the process: While hearing the case in the Board of Tax Appeals, the taxpayer should be confined to the grounds, documents and facts outlined in his protest; similarly, the commissioner would be limited to the finding of facts in the taxpayer's deficiency.

3. The Origins of the Private Letter Ruling

Further thinking on ways to improve dispute resolution between the government and taxpayers led Traynor and Surrey to propose the practice known today as the private letter ruling. Their proposal intended to improve the existing procedure at that time of a "closing agreement" as a method of customized advanced ruling designed to determine the tax consequences of proposed transactions, coincident with a binding agreement between the parties. The proposal suggested forming an agreement between the commissioner and the taxpayer, approved by the Secretary of the Treasury, which would end all disputes related to the facts at hand. Their proposal added that the agreement should relate to either a particular transaction at present or future tax consequences, whether an issue of fact or law. This mechanism would not only inform taxpayers of the Bureau's position on certain tax issues, but also would allow them to rely on this binding agreement, and to plan ahead whether to take a risk of litigating this matter. The taxpayer could also obtain a security against judicial changes or ascertain the Bureau's stand on a future transaction, in which foreseeing the tax consequences may help individuals decide whether to proceed with the transaction.

The future expansion of a "closing agreement" to a revenue ruling, a binding decision resulting from an interpretation or an unclear regulation, the two claimed, would benefit both the taxpayer and the government. The government would benefit because litigation overload would be reduced, as the procedure would prevent taxpayers from arguing later for a different tax consequence. Although taxpayers would still be faced with the prospect of changes in legislation, the ruling would protect them from changes in administrative or judicial resolutions.

C. Ex Post Tax Policy

After a tax matter had already reached the doorstep of the judicial branch, reducing the time required for a resolution was the primary concern for Traynor and Surrey.

1. Reducing the Incentive to Litigate

One of the apparent problems in the late 1930s was the inherent incentive that taxpayers had to file a petition with the Board of Tax Appeals. When given the choice between two identical procedures, taxpayers opted for the one that deferred their tax liability and did not involve prerequisite payment. Traynor and Surrey identified a systematic problem by which filing to the Board did not require prepayment of tax liability. Subsequently, they recommended the unification of the deficiency procedure and the refund procedure or at least requiring a bond to secure the collectibility of the tax. The proposed bond, they said, should not exceed the amount of deficiency in question excluding interest, and the taxpayer would have been able at any time to replace it with other forms of security. The Board would have the authority to waive this security requirement.

An additional method of lowering the volume of tax litigation as a preventive tax policy, suggested Traynor and Surrey, was imposing a requirement to use administrative procedures before filing a lawsuit. They recommended adopting the exhaustion-of-remedies

doctrine in tax matters, which would require certain administrative procedures be initiated and followed before taxpayers could seek relief from the courts.

2. The Establishment of a Single Court of Tax Appeals

Multiple appellate reviews of Board of Tax Appeals decisions created conflicting decisions and uncertainties in the interwar period. Due to differences of opinions among the circuit courts, a decision granted in one circuit court did not close the door to litigating the matter in another circuit court, in hope of reaching a different outcome. For example, in 1930 the Board of Tax Appeals denied a deduction made by a taxpayer for a loss on a sale of property to his wholly owned corporation. That decision was reversed in a matter brought before the Court of Appeals for the District of Columbia in 1934,[59] and the Supreme Court affirmed. Later on, the Second, Eighth and Ninth Circuit Courts of Appeals subsequently rendered similar decisions in such loss deduction cases brought before them. However, in 1939, the Board's view was reconfirmed by a decision of the Seventh Circuit Court of Appeals.[60] Consequently, the Supreme Court granted certiorari and in 1940 held that such losses were not deductible.[61]

In order to eliminate such uncertainties and to achieve uniformity in tax adjudication, Traynor and Surrey suggested passing the exclusive authority to decide cases of income, estate and gift tax to the Board of Tax Appeals. This proposal aimed to transfer the review of tax disputes to professional tax experts who were better qualified than the average court judge. As for appellate review, they recommended establishing a single Court of Tax Appeals, which would have the sole appellate jurisdiction over the board's decisions.[62] The

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59 Jones v. Helvering, 63 App. D.C. 204 (D.C. Cir. 1934).

60 Commissioner v. Griffiths, 103 F.2d 110 (7th Cir. 1939).

61 Commissioner v. Griffiths, 308 U.S.355 (1939).

62 Traynor & Surrey provided other options to establishing a Court of Tax Appeals, such as expanding the jurisdiction of the Court of Tax Appeals for the District of Columbia, or the Courts of Claims. Roger J.

proposed court would have supervised the divisions of the board and stipulated the regulations governing their procedure. Appeals from the Court of Tax Appeals would have required a certiorari from the Supreme Court. If certiorari was denied, both parties had to settle for the Court of Tax Appeals decision, constituting a binding resolution, and not an invitation to litigation, as was the present condition in 1939.

V. PREVENTIVE TAX POLICY: DEFEATED?

After their mutual project, Traynor and Surrey parted ways. Surrey joined the law faculty at Harvard and continued his public service, while Traynor was nominated to the Supreme Court of California. Their proposals to improve the interwar tax system were not fully accepted. While trying to put their innovative philosophy into practice, they encountered the limitations of reality and political constraints. Their philosophy of preventive tax policy, specifically its normative aspect, aroused a storm of criticism.[63] Nevertheless, parts of their proposal were adopted later on, contributing greatly to the development of the U.S. tax system. This section presents the practice of preventive tax policy in Traynor's decisions, along with historical review of the implementation of Traynor and Surrey's proposal, then and today.

A. The Traynor System of Tax Adjudication

Traynor's nomination to the Supreme Court of California did not mark the end of his legacy of preventive tax policy but rather the beginning of its practice. In 1940, Traynor was appointed to the Supreme Court after a public debate over an earlier appointee. Governor

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Traynor & Stanley S. Surrey, *New Roads Toward the Settlement of Federal Income, Estate, and Gift Tax Controversies, 7 Law & Contemp. Probs. 336* (1940).

63 Angell B. Montgomery, *Procedural Reform in the Judicial Review of Controversies under the Internal Revenue Statutes; An Answer to a Proposal*, 34 ILL. L. REV. 151(1939); Aaron G. Youngquist, *Proposal Radical Changes in the Federal Tax Machinery,* 25 A.B.A. J. 291(1939); Seidman, *Proposed Procedural Changes in Federal Tax Practice,* 67 J. OF ACCOUNTANCY 221 (1939); Barrett E. Prettyman, *A Comment on the Traynor Plan for Revision of Federal Tax Procedure,* 27 GEO. L. J. 1038 (1939); William A. Sutherland, New Roads to the Settlement of Tax Controversies: A Critical Comment, 7 LAW & CONTEMP PROBS. 359 (1940).

Culbert Olson had nominated Max Radin, Traynor's old Berkeley colleague, to the state Supreme Court, but the State Qualifications Committee rejected this appointment fearing Radin's radical tendencies.[64] Olson called Radin to ask his advice on a substitute nominee, and Radin recommended Traynor.[65] Appointed at 40 years old, Traynor was the youngest member of the Supreme Court of California, and between 1964 and 1970 he served as its Chief Justice.

In the beginning of the 1930s, jurisprudential ideas of Legal Realism emerged as an anti-formalist reaction and later on attracted many New Deal jurists. To some, Roger Traynor seemed typical of many liberal New Dealers in his belief in administrative expertise and judicial passivity. However, a closer look at his jurisprudence reveals a more complex outlook on law, reform, and the role of the judge as policymaker. [66] Exposed to the ideas of Realism by his Berkeley professor, Thomas Reed Powell, Traynor believed judges should look beyond the mere facts of the case and consider "legislative facts" and "environmental data."[67] He resented the phrase, "judicial activism", and joined the Realists' protest against judges who abused their power to overrule precedents too quickly.

Nevertheless, unlike Legal Realists, Traynor's decisions involved a process of inquiry similar to the Pragmatists' concept of scientific method.[68] Furthermore, Traynor, far from holding a belief in judicial passivity, objected to it and promoted creative legal reasoning.

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64 *Traynor Named to High Bench, Olson Raps Commission for Rejecting Max Radin, Another U.C. Educator,* The L.A. Times, August 1, 1940.

65 BEN FIELD, ACTIVISM IN PURSUIT OF THE PUBLIC INTEREST: THE JURISPRUDENCE OF CHIEF JUSTICE ROGER J. TRAYNOR (2003) *Supra* note 25 at 5.

66 Neil Duxbury contented that realist jurisprudence was never a 'revolt against formalism' and the movement away from formalist legal thinking was very slow and hesitant. To his opinion there was no realist movement but nothing more than as inteletual mood ad "a complex array of messages, some of which seemed rather feeble once places in an institutional context". NEIL DUXBURY, PATERNS OF AMERICAN JURISPRUDENCE 4 (1995). For an intellectual history of the New Deal legal thinking *see* LAURA KALMAN, LEGAL REALISM AT YALE 1927-1960 (2001); and PETER H. IRONS, THE NEW DEAL LAWYERS (1982). For a comprehensive analysis of American legal Realism *see* MORTON HORWITZ, THE TRANSFORMATION OF AMERICAN LAW, 1870-1960: THE CRISIS OF LEGAL ORTHODOXY (1992); WILLIAM NELSON, THE LEGALIST REFORMATION, LAW, POLITICS, AND IDEOLOGY IN NEW YORK 1920-1980 (2001); and LAWRENCE FRIEDMAN, AMERICAN LAW IN THE TWENTIETH CENTURY (2002).

67 Roger J. Traynor, *Better Days in Court for a New Day's Problem*, 17 VAND. L. REV. 109 (1963).

68 BEN FIELD, ACTIVISM IN PURSUIT OF PUBLIC INTEREST: THE JURISPRUDENCE OF CHIEF JUSTICE ROGER J. TRAYNOR (2003) 9-14.

Judicial creativity, he theorized, is when the judge succeeds in persuading the involved parties and the legal community of the necessity of modifying standing law. Legal changes, he believed, develop through those judicial innovations that bridge the law with reality and social changes, and venture "new answers to old questions."[69]

During Traynor's tenure on the California Supreme Court, he promoted these ideas and practiced his philosophy of preventive tax policy. For instance, he maintained the consistency of the law by following the legislative intent. In order to determine the Legislature's state of mind, Traynor tracked the legislative history of the bill and applied cautious reasoning using textual interpretation of the statute. The case of *Roehm v. Orange County*[70] is an example of this form of interpretation. In this case, Traynor had to decide whether a liquor license is taxable intangible property. In reversing the lower court decision, Traynor examined the history of Article XIII §14 of the California Constitution and the legislative intent of its amendments. He concluded that this history showed liquor licenses were not intended to be taxed as personal property subject to ad valorem taxation. Traynor demonstrated how the framers of the amendments of Article XIII and generations of Supreme Court decisions sustained the view that only intangibles listed in the Constitution were taxable property.[71] Foreseeing the administrative problems of future taxation of intangible property, Traynor noted that among the absurdities of such taxation would be taxing life insurance policies, which would result in increasing tax avoidance by exchanging taxable intangible assets for tax-free intangible assets.[72] To be cautious, Traynor added that in case the Legislature was not satisfied with his ruling in this matter, it had the vested power to

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69 Robert B. McKay, *Constitutional Law; Idea in the Public Forum*, 53 CAL. L. REV. 67 (1965).

70 Roehm v. Orange, 32 Cal. 2d 280; 196 P.2d 550; 1948 Cal. LEXIS 223 (Cal. 1948).

71 *Id,* at 285.

72 "Intangible assets are often interchangeable so that exemption of some and taxation of others at high rates would induce taxpayers to convert highly taxable intangibles into tax-free intangibles or to conceal them. Thus, subjection of patents or copyrights to such taxes would lead to the transfer of such rights to foreign corporations in exchange for corporate stock specifically exempted from property taxation by section 212 of the Revenue and Taxation Code." *Id.,* at 290.

amend it. True to his administrative roots, Traynor concluded that it is up to the Legislature and not the local subdivisions of the administration to make such a change.[73]

Influenced by the Realist mood and while trying to prevent unnecessary adjudication of an already complex tax code, Traynor used his stage to call for judicial restraint and warn fellow judges against erroneous interpretation of the law in conflict with its original intent. [74] He stressed the necessity of judicial restraint to preserve American democracy and legal ordering.[75] Activist judges, he thought, undermine the law by making too many changes that impair its stability. He claimed that the Legislature's silence is not a rejection of a rule nor a green light for activist judges to alter it, but a sign of its acceptance.[76] His judicial philosophy

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[73] *Id*. at 291. Another example of Traynor's purposive interpretation seeking legislative intent was the case of Golden State Theatre & Realty Corp. V. Johnson (21 Cal. 2d 493; 133 P.2d 395; 1943 Cal. LEXIS 274. (Cal. 1943)). The taxpayer challenged the taxation of dividends received from its subsidiaries under the Bank and Corporation Franchise Tax Act. The taxpayer claimed that the dividends are deductible from its gross income since they were declared from income arising out of business done in the state. Traynor ruled in favor of the taxpayer by interpreting the legislative text and holding that the corporation was not a holding company because it was actively doing business in the state and not only receiving dividends from its subsidiaries. Traynor interpreted the language of the Bank and Corporation Franchise Tax Act in light of its legislative intent and the purpose of the 1933 modifications. He interpreted the term "doing business" by looking at the legislative history of the act and held that following the decision in the lower court the Legislature amended the definition of doing business and added the provision that holding companies should not be regarded as doing business. Traynor's definition of "doing business" was affirmed by later cases.

[74] Being one of the architects of the Bank and Corporations Franchise Tax Act, Traynor rejected the taxpayer contention for the necessity to amend it to specify that a trustee in bankruptcy conducting the business of a corporation shall be subject to tax as if he were a corporation. District Bond Co. v. Florence Pollack, 19 Cal. 2d 304; 121 P.2d 7; 1942 Cal. LEXIS 364 (Cal. 1942).

[75] Judicial restraint and employing purposive interpretation of the law were at the core of Traynor's decisions. For example, Traynor was faced with a political attack over the use of municipal funds. In this case, he had set the limits on judicial criticism of municipal discretion by requiring exhausting of remedies before the court could interfere in the administrative and legislative branches' actions. He stated: "In the absence of constitutional or statutory limitations the amount of revenue necessary for the needs of a municipality is within the sole discretion of the legislative authorities and this discretion is not subject to judicial interference. The power of courts to interfere in matters of taxation, except as permitted by statute, is limited. The courts cannot pass upon the question of the policy of a tax law or the expediency of the exercise of the taxing body or the wisdom or fairness of the method of distributing the burden of taxation where no provision of the constitution is violated." The importance of this decision is in its prevention of future litigation of political issues under the pretense of misuse of tax money. Rancho Santa Anita v. Arcadia, 20 Cal. 2d 319; 125 P.2d 475; 1942 Cal. LEXIS 279 (Cal. 1942).

[76] Garvey v. Byram, 18 Cal. 2d 279; 115 P.2d 501; 1941 Cal. LEXIS 363; 136 A.L.R. 1137. (Cal. 1941) In another case Traynor commented: "The foregoing statement is particularly applicable here, where it is contended that the silence of the Legislature in 1945 establishes the intention of the Legislature that enacted the provision some eight years previously, even though administrative construction antedating the Green case and in contradiction with it was followed by reenactment of the section without change. It would be as logical to contend that the Legislature thereby adopted the administrative construction. Although legislative silence may sometimes give a clue to legislative intention, it is by no means

was when a rule is long engrained in public policy, it must be presumed that the Legislature took it for granted rather than sought to alter it. Traynor emphasized that it is for the Legislature and not the courts to formulate such policy. In his opinion, the role of the judge was significant in preserving the consistency, predictability, and unity of the code. Inconsistent decisions puzzled both taxpayers and the administration, and created incentives to litigate in order to receive different results.

Nevertheless, Traynor also sought to forewarn the judiciary from ignoring cases that misinterpreted the law. When confronted with a case of erroneous interpretation of the law that created bad precedent, he maintained it is the obligation of the judge to overrule it.[77] The power of precedents is not complete and immutable, he asserted, for erroneous interpretation of the law by the court defeats the purpose of legislation not only for the past but also for the indefinite future.[78] Accordingly, in *Texas Company v. Los Angeles County*[79] Traynor advised taxpayers against thinking the law is fixed and inflexible. There are cases where innovation of the law requires reconsideration of the current legal convention. The judge has to apply "judicial creativity" by identifying this critical juncture of the law and rule out outdated

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conclusive….In short, although recognizing that by silence Congress at times may be taken to acquiesce and thus approve, we should be very sure that, under all the circumstances of a given situation, it has done so before we so rule… Just as dubious legislative history is at time much overridden, so also is silence or inaction often mistaken for legislation." Rosemary Properties v. McColgan, 29 Cal. 2d 677; 177 P.2d 757 (Cal. 1947).

77 An illustration of such preventive tax policy is found in Traynor and Surrey's second project concerning section 820 of the Revenue Code of 1938. Section 820 sought to reduce litigation by mitigating the hardships of erroneous tax returns produced by applying the Statute of Limitation on tax returns. Their mutual project with Professor John Maguire commended this new provision in order to reduce litigation related to tax readjustments between taxable years, but also offered criticism on the remaining loopholes. John M. Maguire, Stanley S. Surrey & Roger J. Traynor, *Section 820 of the Revenue Act of 1938*, 48 YALE L. J. 509 (1939); Maguire, Stanley S. Surrey & Roger J. Traynor, *Section 820 of the Revenue Act of 1938*, 48 YALE L. J. 719 (1939). At that time, several court decisions disallowed refunds for erroneous overpayments made in previous years by applying the statute of limitation. The newly enacted section 820 in the Revenue act of 1938 (Pub. L. No 75-544 §820) was designed to offer relief where the tax results of an earlier year and a later year combined to present an inequitable burden or avoidance. The writers protested against not carrying out the exact recommendations of the House Committee on Ways and Means Subcommittee on Internal Revenue Taxation and the Senate Finance Committee, which aimed to repair inconsistent and erroneous tax treatment while preserving the essential function of the Statue of Limitation.

78 Texas Co. v. L.A. County ,52 Cal. 2d 55, 64; 338 P.2d 440; 1959 Cal. LEXIS 180. (Cal. 1959). Roger J. Traynor, *La Rude Vita, La Dolce Giustizia; or Hard Cases Can Make Good Law*, 29 U. CHI. L. REV. 223, 229-230 (1962).

79 Texas Co. v. L.A. County, 52 Cal. 2d 55, 64; 338 P.2d 440; 1959 Cal. LEXIS 180. (Cal. 1959).

precedents in a manner that will reconcile opposite opinions and will gain the support of the legal community. Taxpayers have no vested rights that there would not be future changes in the law, as it is the constitutional obligation of the Legislature to change the law when needed. Legislation, he thought, has to be flexible in order to sustain the change of time and reality.[80] He viewed the role of the judge as bridging the gap between law and realities of everyday society.

In the case of *Sutter-Yuba Inv. Com.* [81] Traynor employed "judicial creativity" to avoid undesirable reality. Although this seemed to be a straightforward redemption of property case, it had significant consequences for the overall process of calculating the tax liability on delinquent property. In this matter, the taxpayer contended he should not have to pay taxes imposed on delinquent property for the years it was held by the local government. Traynor had to bridge between the "dry law" and the new reality by which local governments held on to delinquent property for a long period until this property was finally sold. A tax policy issue was at stake that could seriously affect the redemption process of tax delinquent property. Traynor decided to reject the taxpayer's contention, and stated that taxes for that period must be included in calculating the redemption cost. He considered the inevitable repercussions of a decision to accept the taxpayer's interpretation of the law. If the county did not require that redemption prices take into account taxes imposed had the property not been

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[80] In the case of Von Hamm-Yong Co. v. San Francisco, 29 Cal. 2d 798; 178 P.2d 745; 1947 Cal. LEXIS 267; 171 A.L.R. 274. (Cal. 1947) Traynor realized that the answer to the case in front of him is not stated in the law, but in practice. Justice and tax policy prevailed in this case over strict application of case law. In this matter, the city of San Francisco challenged a refund of personal property taxes levied on the corporation's property. Traynor denied the city's appeal holding that movement of goods from the place of purchase to the warehouses was due to the fact that they could not been delivered directly to the carriers under the wartime emergency regulations, thus had to be considered a movement in interstate commerce just as it would have been had the goods been delivered directly to the common carriers and held under their control until shipped. In this case, it was clear to Traynor that the shipper has done everything possible to deliver the goods. He has never sold the goods locally and did not have the authority to divert the goods into local trade. So although under the "dry law" the corporate merchandise was subjected to property taxes, Traynor recognized that reality dictated different results and the shipper "should not be penalized because wartime emergency regulations have prevented him from following the normal practice of the business in delivering the goods directly to the common carriers that will carry them to their ultimate destination."

[81] Sutter-Yuba Inv. Co. v. Waste , 21 Cal. 2d 781; 136 P.2d 11; 1943 Cal. LEXIS 310 (Cal. 1943).

deeded to the state, owners would find it advantageous to allow their property to be deeded to the state with the intention of delaying redemption as long as possible to escape taxes that attended ownership. Although the right of redemption until disposal of the property serves the taxpayer's convenience, he stated, it does not enable him to escape taxes for that period while others pay their taxes conscientiously year by year.

Twenty years later another tax redemption case came to Traynor's desk.[82] This time Traynor believed that a wrong judgment might give taxpayers an incentive to loot their tax-deeded property before its seizure by the government. The defendants in this case sold timber cut from tax-deeded land. After being required to pay their taxes, they claimed the amount they paid to redeem the property included taxes on the value added to the land by the timber before it was removed. They asserted that by paying a redemption price based on the value of the land including the timber, they have in effect paid the state for the timber. In rejecting their contention, Traynor was concerned that owners of tax-deeded property would extract its natural resources then argue the harvest is excluded from the tax deed on the property. It was a substantial matter of tax policy, he claimed, to prevent tax delinquency and speculations whether the proceeds from the harvest make it worthwhile to redeem the land or sell it under the tax deed.[83]

Acting as the ultimate professor, Traynor's opinions employed a lean, analytical style of policy analysis.[84] As other pragmatist judges, he framed his opinions with a scientific approach, which portrayed his decisions as objective analysis of the facts and inevitable result

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82 People v. Lucas, 55 Cal. 2d 564; 360 P.2d 321; 11 Cal. Rptr. 745; 1961 Cal. LEXIS 237 (Cal. 1961).

83 "To permit defendants to retain the proceeds from the sale of the timber would be to condone a brazen trespass to property that section 3441 makes a crime and would encourage the stripping of timber and the removal of minerals from tax-deeded lands. It would also encourage tax delinquency, for it would permit the former owner to speculate as to whether the proceeds from the property would be sufficient to justify his redeeming it and would permit him to collect such proceeds until the state took steps to compel an accounting and payment and then defeat the rights of the state by redeeming the property before judgment could be obtained. As the Maxfield case makes clear, the statutes are plainly drawn to preclude such maneuvers." *Id.* at 571.

84 BEN FIELD, ACTIVISM IN PURSUIT OF THE PUBLIC INTEREST: THE JURISPRUDENCE OF CHIEF JUSTICE ROGER J. TRAYNOR, 126 (2003).

of public interest. Moreover, he wrote explanatory judgments providing details and examples, in hope that his judgments would guide taxpayers, Bureau agents and fellow judges in future cases, thus preventing further litigation.

Law's Estate[85] is one example of a Traynor opinion containing details and examples on how to compute marital deductions in estate tax. In this case, the deceased's will provided his estate taxes should be paid out of the residuary estate. The controller subtracted all the allowable deductions including federal estate tax from the fair market value of the estate. Then the controller declared half of the remainder of the estate as marital deduction. The executor of the will objected to this calculation arguing the marital deduction should have been subtracted from the fair market value of the estate *prior* to the deduction of the federal estate tax. Traynor affirmed the controller's computation holding the marital deduction was properly determined. He detailed the way to compute estate tax by first subtracting federal estate taxes to ascertain clear market value on the estate. Only then and from that clear market value, Traynor stated the marital deduction should be determined. This decision appeared to be more a "class exercise" than a traditional judicial opinion and involved a deep understanding of accounting. It was important to Traynor to explain and demonstrate his calculations so it would be clear for future estate executers how to administer the convoluted law. Similar to a textbook solution, Traynor constructed a table comparing the controller's computation to the executor's computation, followed by a detailed explanation of their differences, supported by relevant sections of the Revenue Code.

Another example of Traynor's academic opinions came a few years later, in the dissent opinion of *Rosemary Properties v. McColgan*.[86] At issue was the matter of deductibility of dividends received by a corporation under section 8(h) of the Bank and Corporation Franchise Tax Act. The majority opinion in this case agreed with the plaintiff

[85] Estate of Law v. Kirkwood, 50 Cal. 2d 345; 325 P.2d 449; 1958 Cal. LEXIS 161 (Cal. 1958).
[86] Rosemary Properties v. McColgan, 29 Cal. 2d 677; 177 P.2d 757 (Cal. 1947).

holding that any dividend paid from earnings and profits would be a dividend paid out of income included in the measure of the tax and as such, the dividend was exempt from franchise tax in the hands of the recipient corporation.

In a long and detailed dissenting opinion, Traynor traced the legislative purpose of the dividend allowance as designed solely to prevent double taxation of corporate income by the state, and limited only to dividends declared out of taxable income. In this opinion, Traynor incorporated an illustration of the differences between "income" and "earning and profits"; the latter included a deduction of federal taxes. Next, Traynor provided a mathematical example to demonstrate the differences between net income and earning and profits. His opinion detailed the majority's mistake of allowing the plaintiff to declare dividend out of "earning and profits" in excess of the "net income" although no tax was paid on this excess. Having advised and crafted the Bank and Corporation Franchise Tax Act, Traynor had a thorough and detailed understanding of this legislation. During his academic career, he wrote several articles on the constitutional basis of this act.[87] While referring to its legislative intent Traynor held the plaintiff's interpretation of section 8(h) was not only "administratively unworkable but is inconsistent with the basic structure of the act."[88] He protested against the majority's acceptance of the taxpayer's contention, making error after error, and in fact, changing the provisions of the act so as to be radically different from what the Legislature had sought to adopt.[89] Finally, Traynor criticized the complexity and lack of unity of the

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87 Roger J. Traynor, *National Bank Taxation in California,* 17 CALIF. L. REV. 83-119, 232-57, 456-528 (1929); Roger J. Traynor & Frank M. Keesling, *Recent Changes in The Bank and Corporation Franchise*, *Tax Act,* 21 CALIF. L. REV. 543; 22 CALIF. L. REV. 499 (1933).

88 "Rules of statutory construction are at best only aids in ascertaining the legislative purpose. One of those aids has here been seized upon, in disregard of the plain signposts within the statute and the basic concepts underlying it, to establish administratively unworkable conditions, accord unequal treatment to dividends, and open the way to a more extensive deduction than necessary to achieve the legislative purpose of avoiding double taxation." Rosemary Properties v. McColgan, 29 Cal. 2d 677, 706; 177 P.2d 757 (Cal. 1947).

89 "How can the Legislature state in plainer terms that "net income" is the measure of the tax? ... In light of this language how can it be seriously contended that the measure of the tax is "gross income subject to taxation by the state?" "The opinion in the Green case, however, contains so many errors fundamentally at variance with many provisions of the act that the Legislature cannot reasonably be

Bank and Corporation Franchise Tax Act as mystifying taxpayers, judges, and tax officials, resulting in wrongful judicial interpretation and administrative application.[90] Traynor's opinion was later affirmed by the Supreme Court of California.[91]

In an effort to prevent tax litigation ex post and advance administrative settlement of tax controversies, Traynor established a judicial rule by which taxpayers should avail full information and properly communicate with the tax administration otherwise they can not receive remedies from the court. While sitting in the case of *West Pub. Com. v. McColgan,*[92] he established a requirement that taxpayers provide the Bureau with the necessary information prior to filing a lawsuit with the court. In this case, the taxpayer was a Minnesota corporation engaged in the business of selling law books and other publications. The corporation shipped its books to California from orders taken in California by its employees. However, it refused to file returns under the California Income Tax Act or to furnish any information requested by the commissioner, claiming that the tax levied under the Bank and Corporation Income Tax Act was unconstitutional since California cannot impose a tax on a foreign corporation engaged in interstate commerce. Without the information, the commissioner had no choice but to acquire data from the State Board of Equalization and to estimate the company's income. Traynor rejected the corporation's claims and held it cannot

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presumed to have adopted the construction of the act in that case." *Id.* at 772. This opinion was affirmed by Robertson v. Health Net of California, Inc., 132 Cal. App. 4th 1419, 1427, 34 Cal. Rptr. 3d 547 (Cal. App. 2005) and County of Orange v. Flournoy, 42 Cal. App. 3d 908, 912, 117 Cal. Rptr. 224 (Cal. App. 1974).

90 "A comprehensive tax statute such as the Bank and Corporation Franchise Tax Act exemplifies intricate draftsmanship; it evolves out of the painstaking deliberations and studies not only of public officials but of others interested in tax legislation. Such a statute, wrought from a consideration of many conflicting interests, cannot long retain unity and coherence if one section or another is refabricated by the courts without regard for the structural whole. The technical concepts of the statute, its express provisions, should not lightly be vitiated by facile phrases such as "gone through the tax mill" or "flailed by the taxmaster" that denote a lack of insight into the legislative purpose that binds together the provisions of the statute. If the express words of the statute are overridden by such phrases neither taxpayers nor tax officials can look to the written word of the statute for its authentic meaning, and the already difficult task of understanding the revenue acts becomes hopeless." Rosemary Properties v. McColgan, 29 Cal. 2d 677, 700; 177 P.2d 757 (Cal. 1947).

91 Safeway Stores, Inc. v. Franchise Tax Board, 3 Cal. 3d 745, 91 Cal. Rptr. 616, 478 P.2d 48 (Cal. 1970); Security-First Nat'l Bank v. Franchise Tax Board, 55 Cal. 2d 407, 11 Cal. Rptr. 289, 359 P.2d 625 (Cal. 1961).

92 West Pub. Co. v. McColgan, 27 Cal. 2d 705; 166 P.2d 861; 1946 Cal. LEXIS 348 (Cal. 1946).

call upon the court's help to determine whether agencies acted properly when it refuses to submit issues of fact to such agencies. He concluded that a tax on the net income from interstate commerce did not violate the commerce clause of the Constitution, but more importantly, taxpayers cannot complain of errors in the computation of their tax liability when they refuse to avail themselves to administrative remedies to prevent or correct such errors.

In the case of *Star-Kist Foods v. Quinn,*[93] Traynor continued to implement this idea establishing a rule by which taxpayers could not receive remedies from the court unless they had exhausted their remedies with the tax administration. The issue in this case was erroneous assessments. Although the taxpayer had the option to apply to the Board of Equalization for the correction of his return, he instead filed a claim in court seeking a writ of mandate against the tax assessor to cancel the assessments. Traynor was familiar with this issue as he had written extensively on the problem of taxpayer's choice according to the affordability of the dispute resolution mechanism. He claimed that taxpayers often chose the less-expensive option of filing a court claim before exhausting other appellate mechanisms and thus overloading the court system with unnecessary litigation. Reversing the trial court judgment, Traynor held that as a matter of law the taxpayer was not required to file with the Board of Equalization before it sought a judicial determination. However, as a matter of tax policy, the taxpayer had a plain, speedy, and adequate remedy in the ordinary course of law by paying the tax under protest and seeking recovery thereof.[94]

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93 Star-Kist Foods v. Quinn, 54 Cal. 2d 507; 354 P.2d 1; 6Cal. Rptr. 545 (Cal. 1960).

94 "Star-Kist, however, could have obtained relief by paying its taxes under protest and suing for recovery thereof …Mandate is ordinarily denied when the petitioner has a plain, speedy, and adequate remedy in the ordinary course of law….In more recent cases, however, the adequacy of such remedies has been considered and mandate has been denied.… The fact that Star-Kist filed its petition for mandate before the assessment was complete, however, does not affect the adequacy of its remedy by payment of taxes under protest and suit for recovery thereof." *Id*. at 511.

B. Today's Implementation of Preventive Tax Measures

Although the idea of creating a single tax tribunal was suggested earlier, only by the late 1930s had the idea gained momentum, primarily due to Traynor and Surrey's proposal.[95] Their proposal differed in the administrative and judicial authority this court would hold. However, Traynor and Surrey's proposal for a single Court of Tax Appeals was not executed due to objections by members of Congress who did not want to grant life tenure and judicial power to the Board members. Many articles have been written on the need for final judicial authority in tax matters,[96] but the idea has continuously been rejected by the legislative branch.[97]

A few years later, the Revenue Act of 1942 changed the name of the Board to the Tax Court of the United States. Although it seems this was only a cosmetic change, in fact, the act elevated the status of the Board to a judicial body and its members to judges. Two decades later, the Tax Reform Act of 1969 removed the court's description from an agency within the executive branch and elevated its status to a court under Article I of the Constitution, as suggested by Traynor and Surrey. This act also created a category of small tax cases, which were decided by special trial judges, and removed the burden of small tax matters from the Tax Court.

One of the most significant changes the Tax Court has experienced in the last decade is in the subject of ruling in questions of fact, which Traynor and Surrey criticized in their

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95 Justice Robert H. Jackson also recommended the establishment of a centralized tax tribunal as a final appellate tax review, stressing its retrospective character as interpreting tax cases in light of the tax changes over the years. He suggested that the members of the congressional committee will sit in this court, with a notion of harmonious interpretation of the tax court. Stark, at 188.

96 Staley S. Surrey, *Some Suggested Topics in the Field of Tax Administration*, 25 WASH. U.L.Q. 399, (1940); Erwin N. Griswold, *The Need for a Court of Tax Appeals*, 57 HARV. L. REV. 1153 (1944); Caplin & Brown, *A New U.S. Court of Tax Appeals*: S. 678, 57 TAXES 360 (1979); Martin D. Ginsberg, *Making Tax Law Through Judicial Process*, 70 A.B.A. J. 74 (1984). For historical overview on this idea *see* Todd H. Miller, *A Court of Tax Appeals Revisited*, 85 YALE L.J. 228 (1975).

97 The proposal for federal judicial reform in 1997 rejected the idea of a separate tax of court appeals and suggested it be centralized in the federal Circuit system. Commission on Structural Alternatives for the Federal Courts of Appeals, Final Report 73 (Dec. 18, 1998). PL 105-119, 1997 HR 2267.

reform plan. Today's Tax Court judges are involved in pre-trial activities, and when necessary, retain the facts of the case.[98] Unlike the past, when judges were limited to the information in the petition or the deficiency letter, with today's means of communication, Tax Court judges have become involved in obtaining the necessary information themselves via telephone, facsimile, emails, conferences, and other electronic methods. Moreover, the Tax Court has established today an ex ante preventive practice with the California Bar by which special trial judges act as mediators in an effort to settle cases prior to regular sessions.[99] These developments have reduced delays in the Tax Court's docket and enabled the parties to save expensive judicial time.

Yet, today's Tax Court appellate review has not changed and it is still in the hands of the various Circuit Courts. Throughout the years, the principle by which appeals from the District Courts are confined to "clearly erroneous" cases was also applied to appeals from the Tax Court, thus limiting appellate review to unusual matters.[100] However, there is still no requirement for prepayment of tax liability of any bond in order to file with the Tax Court. For those reasons and more, Traynor and Surrey's proposals still have merit today. Their goals of lowering the incentive to litigate tax matters, standardizing tax decisions and minimizing the current tax uncertainties remain relevant.

One of Traynor and Surrey's successes was enacting a binding taxpayer-government agreement. For years, the Bureau of Internal Revenue refused to apply the idea of a "closing agreement" to future transactions. Its caution originated in the notion that the determination of a commissioner in one case cannot bind his successor or other taxpayers outside the agreement. Traynor and Surrey used their influence in the Treasury and incorporated this

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98 Theodore Tannenwald, Jr., *The United States Tax Court: Yesterday, Today and Tomorrow: Erwin N. Griswold Lecture before the Annual Meeting of the American College of Tax Counsel, San Antonio, Texas, January 23 1998,* 15 Am. J. Tax Pol'c 1, 6 (1998).

99 *Id*. at 7.

100 *Id*. at 4 (1998).

mechanism of taxpayer-government agreement in the Revenue Act of 1938.[101] They also added a requirement that taxpayers show a bona fide motive in seeking the ruling. This measure was necessary to prevent the Bureau from becoming a huge information authority abused by tax avoiders. The idea of a private letter ruling as we know it today originated in Traynor and Surrey's concept of a "closing agreement" designed to apply to future transactions. Its extensive use today as a preventive mechanism for tax disputes is no doubt by virtue of Traynor and Surrey's project.

Today's most challenging problem in international taxation is addressing the implications of Cross-Border Tax Arbitrage, such as transfer pricing transactions. The use of these types of transactions as a form of tax avoidance and income allocation among different taxing jurisdictions became widespread with the development of multinational organizations. "Transfer pricing transactions" refers to the pricing of goods and services between a parent company and its foreign subsidiary, or between various divisions of a multinational corporation. Given that the parties in this transaction are clearly related, this mechanism is used to affect the profits of different divisions in the company, along with the company's overall tax liability.

In conjunction with traditional mechanisms for confronting this phenomenon, such as enacting laws and regulations, the U.S. government, followed by other governments around the world, developed Advance Pricing Agreements (APA's) to prevent future tax litigation over international transactions.[102] An APA is an agreement between the taxpayer and the government relating to a future transaction, by which the parties agree upon the price and time period of a specific transaction. This mechanism prevents future litigation and

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101 Revenue Act of 1938, Pub. L. No. 75-544, § 801, 52 Stat. 447, 573 (amending Revenue act of 1928, Pub. L. No. 70-562, § 606, 45 Stat. 791, 874). The reform added that a closing agreement may be related not only to a past tax year already closed, but also to a present tax year not yet terminated, or to a future tax year not yet commenced.

102 For more on the emergence of APAs, see Diane M. Ring, *On the Frontier of Procedural Innovation: Advance Pricing Agreements and the Struggle to Allocate Income for Cross Border Taxation, available at:* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=235275

guarantees that the taxpayer is acting in good faith. Today we witness bilateral and multilateral APAs that involve taxing authorities in other countries relevant to the transaction, and protect the taxpayer from double taxation and assessments procedures.

This procedural innovation is preventive tax policy *per se,* which originated back in the 1940s with Traynor's & Surrey's clever idea of using a closing agreement for future transactions. It demonstrates that preventive tax policy can serve as a model for reducing litigation and preventing controversies in other areas of the law and, most especially, how 1940's public policy continues to shed light on current developments in the legal system.

Traynor and Surrey's idea of preventive tax policy is especially timely as the government is struggling to improve the effectiveness, integrity and fairness of our tax laws. Various proposals have been drafted suggesting the transformation to tax system based on a consumption tax. Some of those proposals have suggested enacting a value-added tax, a national sales tax, or a broad individual and business postpaid consumption tax.[103] Those proposals may revive the need to reconsider changing the Tax Court's status to a National Court of Tax Appeals, simplifying the tax code and unifying deficiency and refund litigation, as Traynor and Surrey proposed nearly 70 years ago.

VI. CONCLUSION

"There is something basically wrong in a procedure which enables so many cases to travel the long, expensive and futile route up to the threshold of a judicial settlement only to retrace their steps at that point to an administrative settlement or to be abandoned altogether by the taxpayer or the government."(Roger J. Traynor and Stanley S. Surrey)[104]

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[103] For consumption tax proposals see ROBERT E. HALL & ALVIN RABUSHKA, THE FLAT TAX (1995); DAVID BRADFORD, UNTANGLING THE INCOME TAX (1986); The Armey-Shelby Flat Tax, H.R. 2060 and S.1050; LAURENCE S. SEIDMAN, USA TAX, A PROGRESSIVE CONSUMPTION TAX (1997); S. 722 The Nunn-Domenici USA Tax; Simple, Fair & Pro-Growth: Proposals to Fix America's Tax System President's Advisory Panel on Federal Tax Reform, 21-22 (Nov. 2005).

[104] Roger J. Traynor & Stanley S. Surrey, *New Roads Toward the Settlement of Federal Income, Estate, and Gift Tax Controversies,* 7 LAW & CONTEMP. PROBS. 336, 339 (1940).

Between World War I and World War II, the United States tax system underwent a dramatic change with the evolution of the individual income tax. In about 20 years, the income tax went from a novel measure that generated very little revenue to a major source of income for the federal government. One of the consequences of that development was that the tax code became very complex. Public discontent with the system grew and tax litigation increased, along with tax evasion.

During the 1930s, the interwar system of tax disputes involved too much law, and served as an open invitation for litigation. Multiple appellate reviews of the Board of Tax Appeals decisions by the various Circuit Courts enhanced tax uncertainties. Decisions in tax matters differed from one Circuit Court to another. Until the Supreme Court resolved the issue (if ever) the tax system was characterized by a great deal of uncertainty. Moreover, the lack of a proper limit or precondition for a petition for the Board of Tax Appeals clogged the system, creating huge delays. It could take up to nine years to resolve a case, preventing in the meantime a uniform application of the law. This situation created externalities and unnecessary costs to both the government and the taxpayer.

Some can predict the consequences of changes in present legal treatment by capturing the resolution of old problems based on current studies. Very few are the one who can foresee entirely new problems and predict the affect alternative reform proposals will have on different set of circumstances.[105] The transformation of the tax system from 'class tax' to 'mass tax' marked the end of the "innocent" era and the evolution of tax avoidance followed by complicated tax legislation. It reflected the genesis of sophisticated tax avoidance schemes commonly endorsed today by accounting firms and tax lawyers.

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[105] On the ability to predict legal changes see: Robert Charles Clark, *The Morphogenesis of Subchapter C: An Essay in Statutory Evolution and Reform*, 87 YALE L. J. 90 (1978).

In 1938 and 1939, two relatively unknown tax administrators came together to propose a major overhaul of the tax system. One was Roger Traynor, who would go on to be recognized as one of the most accomplished and brilliant state judges in U.S history.[106] The other was Stanley Surrey, who later would be called the greatest tax scholar of his generation.[107] Traynor and Surrey were of those who not only identified the shift in public dislike of the convoluted tax system, but also predicted the proper way to halt the progression of this development.

Traynor and Surrey advocated a decentralized, simpler, and more accessible system, in which the taxpayer could appear with his attorney and his books and solve the matter with a Bureau of Internal Revenue technical staff member in the field office close to his residence. The two aimed to create a unified division staff powerful enough to settle tax disputes and to expedite their resolution. They regarded as a success any case that was settled by the administration and avoided judicial review. There was a need in the interwar period to draw a clear conceptual line between administrative and judicial review, crossing it only in exceptionally complicated matters.

In addition to improving the administrative settlement procedure, Traynor and Surrey's preventive tax policy sought to prevent disputes from arising by decreasing the friction between taxpayers and the government.[108] They contended that it is necessary for the legislative, executive, and judicial branches to implement the idea of a preventive tax policy. Creating a coherent and simple tax code enables taxpayers to comprehend the correct tax treatment. Obtaining full and accurate information from the taxpayer in a protest letter is the next step for the executive branch to dispose of cases that otherwise would block the system.

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106 American legal historian Harry N. Scheiber wrote of him, "[i]n any list of the most admired and influential state judges in the nation's history, Traynor stands at the very top level." BEN FIELD, ACTIVISM IN PURSUIT OF THE PUBLIC INTEREST: THE JURISPRUDENCE OF CHIEF JUSTICE ROGER J. TRAYNOR, ix-xi (2003).

107 Erwin N. Griswold, *In Memoriam: Stanley S. Surrey*, 98 HARV. L. REV. 329, 331 (1984).

108 Id. *supra* note 7 at 344.

Then the judiciary could focus on legal, rather than factual, questions ensuring taxpayers fair and fast application of the law to their case.

Many of the problems that plagued the interwar tax system remain today. Tax acts have become more and more complex in their attempt to close loopholes exploited by shrewd tax attorneys. Changes of time and circumstances or legal treatment create uncertainties that must be settled immediately before developing into tax disputes. This process results in increased tax litigation, which in turn results in contradictory and inconsistent legal doctrines. The incentive to litigate tax matters in the court has not lessened throughout the years. Therefore, today, these dilemmas continue to occupy practitioners and scholars who are striving to improve the current tax system. Traynor and Surrey called for administrative guidance on a regular basis to prevent taxpayers from resorting to litigation in an effort to achieve such guidance from the judiciary. By implementing their proposals one might hope to "return to innocence" and reduce the uncertainties that surround tax matters, while restoring the trust between taxpayers and the government.

Throughout their careers, Traynor and Surrey continued to promote their philosophy of preventive tax policy. As professors, consultants, and a state Supreme Court judge, they no doubt influenced the tax system.[109] After joining the law faculty at Harvard, Surrey advanced preventive tax policy through his lectures. In 1961 Surrey became assistant secretary of the Treasury for tax policy. While speaking in classrooms, professional conferences or testifying before federal committees, he continued to emphasize the need for simplifying the code as a preventive measure.[110]

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[109] In Sept. 9, 1952, while continuing to suggest improvement of the tax administration, Surrey published a paper supporting the separation of the Bureau of Internal Revenue from the Treasury placing it in the executive branch of the government. The paper was delivered in the 1952 meeting of the National Tax Association, in Toronto, Canada. Stanley s. Surrey, *A Comment on the Proposal to Separate The Bureau of Internal Revenue From the Treasury Department*, 8 TAX L. REV. 155 (1953).

[110] In one of his lectures at the University of New York at Buffalo, Surrey commented: "The achievement of tax simplification requires a high measure of sheer ingenuity mixed with an intelligent weighing of what is valuable complexity proper to achieve needed fairness and what is expendable refinement and

Traynor's administrative experience established his reputation as a tax expert and an architect of California's tax system. In an attempt to provide as much guidance possible to prevent the same issues from being relitigated, Traynor's opinions resembled mathematical proofs, containing examples, explanations, and references. He used textual interpretation and frequently cited the language of the law to demonstrate his accordance with it and to maintain its legislative intent. Traynor's opinions interpreted the text in a straightforward way, explaining the relationship between words so readers could accept that he was not adding new meaning but applying "simple rules of grammar" and clear meaning of the text as both reason and justice dictated.[111]

His insights on tax policy and his experience from both the academic and the government side echoed through his tax opinions.[112] His reputation allowed him to continue and advance his philosophy of preventive tax policy from his prestigious stage.[113] In 1970, Traynor retired from the Supreme Court and returned to Berkeley, where he taught and wrote dozens of articles until his death in 1983. Although he is mostly known for his non-tax adjudication, his legacy of preventive tax policy continues to contribute to today's tax debate.

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detail. …Where simplification is possible without pain to the taxpayers involved, and without serious loss of revenue, it will obviously be adopted as soon as the solution is perceived." The James Mccotmick Mitchell Lecture by the Honorable Stanley S. Surrey Assistant Secretary of the Treasury at the School of Law State University of New York at Buffalo, April 21, 1966, in STANLEY S. SURREY, FEDERAL TAX POLICY IN THE 1960'S, 25 (1966).

111 Estate of Law v. Kirkwood, 50 Cal. 2d 345, 355; 325 P.2d 449; 1958 Cal. LEXIS 161 (Cal. 1958). Another example to Traynor's use of legislative history to track legislative intent in the case of *Bray v. Jones* where Traynor examined the legislative history of the Political Code and the idea behind its amendments. So he noted that in 1895 the Legislature adopted an amendment replacing the word "percentage" with the word "penalty". Traynor clarified that the choice of words was not incidental and its purpose was "not to inaugurate a new concept but to lend greater precision to the old." W. F. Bray v. Jones, 20 Cal. 2d 858; 129 P.2d 357; 1942 Cal. LEXIS 344 (Cal. 1942).

112 Don Barrett, Traynor's clerk and friend, called the period from 1945 to 1956 the "Long Court" for its long and unchanged composition. During this period Traynor became a "leading state court judge in the nation" who set a high literary standard for judicial writing. Donald P. Barrett, *The Supreme Court of California, 1981-1982 In Memoriam- Roger John Traynor: Master of Judicial Wisdom*, 71 CALIF. L. REV. 1060 (1983).

113 Traynor wrote 892 opinions and 75 law review articles. BEN FIELD, ACTIVISM IN PURSUIT OF THE PUBLIC INTEREST: THE JURISPRUDENCE OF CHIEF JUSTICE ROGER J. TRAYNOR, 121 (2003). In the field of taxation, Traynor wrote about twenty-five majority opinions and over twenty dissenting opinions. For a list of Traynor's tax decisions *see* Kragen, at 813. On the judicial philosophy of Traynor *see* John W. Poulos, *The Judicial Philosophy of Roger Traynor,* 46 Hastings L.J. 1643 (1995).