CUSTOM AND THE RULE OF LAW IN THE ADMINISTRATION OF THE INCOME TAX

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ABSTRACT

From the early years of the federal income tax to the present, the Internal Revenue Service (IRS) has engaged in what might be termed "customary deviations" from the dictates of the Internal Revenue Code, always in a taxpayer-favorable direction. A prominent current example is the IRS's "don't ask, don't tell" policy with respect to employee-retained frequent flier miles; in a 2002 announcement (which, as of 2012, is still in force), the IRS indicated that such miles were technically within the scope of the statutory definition of gross income, but that the IRS had no intention of enforcing the law. This Essay describes and evaluates the phenomenon of administratively-created customary deviations from the Code. After defining the concept of customary deviations and explaining why such deviations are sometimes attractive to tax administrators, the Essay offers a brief historical survey of customary deviations, paying particular attention to the pre-1984 treatment of a miscellany of fringe benefits of employment, and to a spate of recent announcements that the IRS would not enforce the Code's anti-loss-trafficking rules in certain contexts. The Essay also explains how the development of customary deviations has depended on the absence of third-party standing in tax litigation, and how the lack of any judicial check on unauthorized giveaways by tax administrators threatens rule-of-law values. It concludes with a proposal for legislation aimed at retaining the practical advantages of customary deviations while assuaging rule-of-law concerns.

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INTRODUCTION

A recurring theme in discussions of the relationship between custom and the law is the tension between the practical advantages of custom and the threat custom may pose to rule-of-law values.[1] This Essay considers how that tension has played out over almost a century of administration of the federal income tax. It begins with a prominent example of the conflict between tax law and custom.

The attorneys in the Chief Counsel's Office of the Internal Revenue Service's (IRS) who are charged with writing private letter rulings and other forms of unpublished guidance usually labor in obscurity—but not when the taxation of frequent-flier miles is at issue. A story published in the *Wall Street Journal* on November 28, 1995, explained that an IRS technical advice memorandum (TAM)[2]—which had been issued months earlier without attracting any interest from the media—implied that business travelers had taxable income when they were allowed to retain for personal use frequent-flier miles generated by air travel paid for by their employers.[3] According to the *Wall Street Journal*, a "storm of protest [was] gathering" over the implication of the TAM.[4] In a remarkably quick response, on the same day the story appeared in the *Wall Street Journal* an IRS "senior

1. For a classic statement of the tension between custom and the rule of law, see generally Stanley Diamond, *The Rule of Law Versus the Order of Custom*, 38 SOC. RES. 42 (1971). The tension identified by Professor Diamond, however, is somewhat different from the tension discussed in this Essay. In Diamond's view, "[c]ustom . . . is the modality of primitive society; law is the instrument of civilization, of political society sanctioned by organized force." *Id.* at 47.

2. I.R.S. Tech. Adv. Mem. 95-47-001 (July 11, 1995).

3. Tom Herman, *Frequent-Flier Miles May Become IRS Target*, WALL ST. J., Nov. 28, 1995, at A3.

4. *Id.*

spokesman" told the *New York Times*, "We have no particular compliance activities geared toward the taxation of frequent flier miles and we don't anticipate any . . . . I want to make sure that people don't overreact."[5] With the storm of protest averted, taxpayers and their employers continued not to report the value of employee-retained frequent-flier miles on Forms W-2 and 1040, and the IRS continued to look the other way.[6] All remained quiet on the frequent-flier tax front until 2002, when the IRS bestirred itself to issue an announcement affirming the status quo:

> There are numerous technical and administrative issues relating to these benefits on which no official guidance has been provided, including issues relating to the timing and valuation of income inclusions and the basis for identifying personal use benefits attributable to business (or official) expenditures versus those attributable to personal expenditures. Because of these unresolved issues, the IRS has not pursued a tax enforcement program with respect to promotional benefits such as frequent flyer miles.
>
> Consistent with prior practice, the IRS will not assert that any taxpayer has understated his federal tax liability by reason of the receipt or personal use of frequent flyer miles or other in-kind promotional benefits attributable to the taxpayer's business or official travel. Any future guidance on the taxability of these benefits will be applied prospectively.[7]

Ten years later no "future guidance" has appeared, and the de facto tax-exempt status of employee-retained frequent-flier miles remains intact.[8]

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5. Robert D. Hershey, Jr., *IRS Backs Down on Frequent-Flier Miles*, N.Y. TIMES, Nov. 28, 1995, at B14 (quoting Frank Keith) (internal quotation marks omitted).

6. Darrell L. Oliveira, *The Taxability of Frequent Flyer Credits Earned by Employees: Why the IRS Has Remained Silent on the Issue*, 4 U. PA. J. LAB. & EMP. L. 643, 643–44 (2002) (describing continued IRS inaction through 2002).

7. I.R.S. Announcement 2002-18, 2002-10 I.R.B. 621.

8. The tax status of frequent-flier miles resurfaced early in 2012, in a nonemployment context, when the *Los Angeles Times* reported that Citibank had issued Forms 1099-MISC to persons to whom it had given frequent-flier miles as rewards for opening accounts. David Lazarus, *Tax Man Leaves Fliers up in the Air*, L.A. TIMES, Jan. 24, 2012, at B1. Citibank apparently concluded—reasonably enough—that Announcement 2002-18, 2002-10 I.R.B. 621, did not cover this situation because it discussed only "promotional benefits attributable to the taxpayer's business or official travel," *id.* In response to a reporter's question, an IRS spokesperson, Michelle Eldridge, commented, "When frequent-flier miles are provided as a premium for opening a financial account, it can be a taxable situation subject to reporting under current law." David Lazarus, *Taxing Airline Miles Flies in the Face of Reason*, L.A. TIMES, Jan. 31, 2012, at B1 (quoting Michelle Eldridge) (internal quotation marks omitted). It does not

Despite the reference to questions of timing and valuation, nothing in the 2002 announcement suggests any reason why such benefits would not be included (at some time and in some amount) within the scope of the statutory definition of "gross income" as including "all income from whatever source derived."[9] Moreover, the announcement does not suggest that frequent-flier miles would fit within any statutory exclusion from gross income. To the contrary, the announcement appears to assume the statutory taxability of employee-retained frequent-flier miles, and the vast majority of commentators have agreed with that assumption.[10] For reasons of administrative convenience—to avoid the timing and valuation problems referred to in the 2002 announcement—the IRS has decided to create a de facto, or customary, gross income exclusion, despite the absence of any statutory authority for its position.

This Essay describes and evaluates the phenomenon of administratively created customary deviations from the dictates of the Internal Revenue Code. Part I defines the concept of customary deviations, distinguishes it from several other phenomena of tax administration (including mere underenforcement of the law and dubious protaxpayer administrative interpretations of the Code), and explains why customary deviations are sometimes attractive to the Treasury and the IRS. Part II offers a brief historical survey of customary deviations, paying particular attention to the pre-1984 treatment of a miscellany of fringe benefits of employment, and to a spate of recent announcements that the IRS would not enforce the anti-loss-trafficking rules[11] in certain contexts. Part III explains how

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appear, however, that the IRS is making any attempt to enforce the taxability of such premium miles against customers of other (non-1099-issuing) banks. *See id.* (quoting an IRS spokesperson, who noted that the taxability of benefits, such as frequent-flier miles, "depends on the nature, value, and other facts and circumstances surrounding the particular incentive" (quoting Eldridge) (internal quotation mark omitted)).

9. I.R.C. § 61(a) (2006).

10. *See, e.g.*, Joseph M. Dodge, *How To Tax Frequent Flyer Bonuses*, 48 TAX NOTES 1301, 1302 (1990) ("This situation falls squarely under the expanded 'inconsistent events' formulation of the 'tax benefit rule' as formulated by the Supreme Court . . . ." (quoting Hillsboro Nat'l Bank v. Comm'r, 460 U.S. 370, 386–87 (1983))); Jonathan Barry Forman, *Income Tax Consequences of Frequent Flyer Programs*, 26 TAX NOTES 742, 743–44 (1985) (arguing that frequent-flier benefits are fringe benefits and are unlikely to be excluded as a "working condition fringe"); Oliveira, *supra* note 6, at 646–47 (noting that retained frequent-flier miles represent "a clear accession to wealth and would therefore appear taxable"); Lee A. Sheppard, *Collecting the Tax on Frequent Flyer Benefits*, 59 TAX NOTES 1140, 1141 (1993) (describing a frequent-flier benefit as a "fringe benefit taxable as compensation").

11. *See generally* I.R.C. § 382 (Supp. IV 2011) (setting forth the anti-loss-trafficking rules).

the development of customary deviations has depended on the absence of third-party standing in tax litigation and how the lack of any judicial check on unauthorized giveaways by tax administrators threatens rule-of-law values. It also proposes legislation aimed at retaining the practical advantages of customary deviations while assuaging rule-of-law concerns.

I. THE WHAT AND WHY OF CUSTOMARY DEVIATIONS

As the term is used here, a customary deviation is an established practice of the tax administrators (the IRS and the Treasury Department) that deviates from the clear dictates of the Internal Revenue Code. Customary deviations are always protaxpayer for the simple reason that taxpayers could and would successfully challenge in court any administrative attempt to deviate from the statute in an antitaxpayer direction. Being well aware of this fact, the tax administrators have demonstrated no interest in antitaxpayer deviations. Sometimes no official pronouncement of any sort discloses the existence of a customary deviation, as in the case of the nontaxation of frequent-flier miles prior to the 1995 dustup. In other cases, the IRS—generally after finding itself in a tight spot, sometimes as a result of its own bungling—sends out a spokesperson or issues an announcement to explain, quite frankly, that the IRS has no intention of enforcing some aspect of the law. This is exemplified by the 1995 remarks of a "senior spokesman"[12] and the 2002 formal announcement, both relating to frequent-flier miles. In still other cases, the IRS issues a revenue ruling baldly stating, without any explanation or analysis, that the statute does not say what it clearly says. For example, a 1957 revenue ruling states, with no explanation whatsoever and in conflict with the doctrine of constructive receipt, that a game-show contestant who turns down an in-kind prize does not have to include the value of the prize in gross income.[13]

Customary deviations are distinct (albeit with some fuzziness around the edges of the distinctions) from three other phenomena. The first is a protaxpayer interpretation of the Code that may seem dubious or even insupportable in terms of the literal language of the Code, but which would almost certainly be adopted by the courts if the IRS were to reverse its position and taxpayers were to challenge

12. Hershey, *supra* note 5.

13. Rev. Rul. 57-374, 1957-2 C.B. 69; *see also infra* text accompanying note 36.

the new IRS position. For example, the sweeping language of I.R.C. § 61—"gross income means all income from whatever source derived"[14]—provides no foundation for the exclusion from gross income of imputed income from services (that is, the value of services one performs for oneself) and from property (that is, the rental value of owner-occupied housing and consumer durables). The exclusion of such benefits dates from the dawn of the income tax and is so central to the structure of the income tax that it is inconceivable that the courts would support an administrative effort to reverse that exclusion.[15] In contrast, the administrative exclusion of frequent-flier miles is of relatively recent vintage and is not central to the structure of the income tax. As a result, it is very likely that the courts would support an IRS effort to tax employee-retained frequent-flier miles, were the IRS to have a change of heart on this issue.[16] No doubt there are some borderline practices that could arguably be grouped either with imputed income or with frequent-flier miles, but in most cases the distinction is reasonably clear.

The second phenomenon is simple underenforcement of the law without any indication (beyond the mere underenforcement) that the IRS acquiesces in widespread noncompliance with the Code. For example, an information-reporting provision of the Code results in tipped restaurant employees generally reporting income equal to 8 percent of restaurant sales.[17] For the most part, the IRS is content to enforce the income tax on the tips subject to information reporting, without making a serious effort with respect to the other half (roughly speaking) of actual tip income.[18] Despite this underenforcement, the

14. I.R.C. § 61(a) (2006).

15. BORIS I. BITTKER, MARTIN J. MCMAHON, JR. & LAWRENCE A. ZELENAK, FEDERAL INCOME TAXATION OF INDIVIDUALS ¶ 3.03[1] (3d ed. 2002) ("These items are not exempted from tax by specific statutory provisions, but congressional silence on the subject is clearly tantamount to an affirmative grant of immunity.").

16. For consideration of the possibility that what begins as a customary deviation may acquire the force of law over time, see *infra* notes 37–45 and accompanying text.

17. *See* I.R.C. § 6053(a), (c)(3)(A), (c)(4) (2006) (providing that a food or beverage establishment employing more than ten employees on a typical business day must, if the tipping of employees is "customary," allocate among employees who customarily receive tips "an amount equal to the excess of—(i) 8 percent of the gross receipts . . . over (ii) the aggregate amount [of tip receipts] reported by such employees to the employer").

18. *See* United States v. Fior d'Italia, Inc., 536 U.S. 238, 240 (2002) (upholding the IRS practice of assessing FICA taxes owed by a restaurant on tips unreported by its employees, based on an estimate of aggregate tips received by all employees of the restaurant, without any attempt by the IRS to assess income taxes against individual employees with unreported tip income).

unequivocal position of the IRS is that taxpayers have an obligation to report 100 percent of their actual tip income. According to the first page of the IRS publication *Reporting Tip Income*,[19] "[a]ll tips you receive are income and are subject to federal income tax."[20] This is, of course, very different from the IRS's announcement that it "will not assert that any taxpayer has understated his federal tax liability by reason of the receipt or personal use of frequent flyer miles,"[21] and from its conclusion in a revenue ruling that turned-down game-show prizes are not includible in gross income.[22]

Finally, customary deviations are distinct from mere dubious protaxpayer interpretations of the Code by the Treasury Department or the IRS. A dubious protaxpayer interpretation at least pays lip service—and sometimes considerably more than lip service—to the law on the books and purports to apply that law. As an example, consider proposed regulations issued in 1992, which would have extended the exclusion of I.R.C. § 101(a) for life-insurance proceeds "paid by reason of the death of the insured" to "qualified accelerated death benefits" that are paid by an insurer to a terminally ill insured within twelve months of the expected death of the insured.[23] Although a prominent commentator sharply criticized the proposed regulations as irreconcilable with the statutory language,[24] the IRS Commissioner at the time the proposed regulations were issued defended them as a legitimate reading of the statute.[25] By contrast, a customary deviation is characterized either by the IRS simply conceding that it has no intention to enforce the law (as with frequent-flier miles) or by the

19. I.R.S. Publ'n 531 (Feb. 23, 2012), *available at* http://www.irs.gov/pub/irs-pdf/p531.pdf.

20. *Id.* at 1.

21. I.R.S. Announcement 2002-18, 2002-10 I.R.B. 621.

22. Rev. Rul. 57-374, 1957-2 C.B. 69.

23. Prop. Treas. Reg. § 1.101-8, 57 Fed. Reg. 59,319, 59,320 (Dec. 15, 1992). The proposed regulations were never finalized because the addition of § 101(g) to the Code in 1996 provided detailed statutory rules for the exclusion of accelerated death benefits. *See* Health Insurance Portability and Accountability Act of 1996, Pub. L. No. 104-191, tit. III, subtit. D, § 331, 110 Stat. 1936, 2067 (codified as amended at I.R.C. § 101(g) (2006)).

24. *See* Lee A. Sheppard, *The Goldberg Variations, or Giving Away the Store*, 58 TAX NOTES 530, 533 (1993) ("'By reason of the death of the insured' means what it says—death." (quoting I.R.C. § 101(a)(1))).

25. *See id.* ("'By reason of,' [IRS Commissioner Fred T. Goldberg] argued, does not necessarily require that the death already have occurred."); *see also* James P. Holden, *Lee Sheppard's Grumpy Attack*, 58 TAX NOTES 1130, 1131 (1993) ("[T]he section 101(a) exclusion for payments 'by reason of the death of the insured' is broad enough to permit payments made by reason of imminent death . . . .").

IRS stating without explanation—because no plausible explanation is available—that the statute means what it obviously does not.

Two important commentators would disagree with this Essay's claim that customary deviations are distinct from mere dubious protaxpayer interpretations of the statute. In a thoughtful recent article, Professors Alice Abreu and Richard Greenstein offer an in-depth examination of the long-standing practice of the Treasury Department and the IRS of not enforcing the full sweep of the § 61(a) definition of gross income, as elaborated upon by the Supreme Court in *Commissioner v. Glenshaw Glass Co.*,[26] with respect to various sorts of in-kind benefits.[27] They convincingly demonstrate that these failures to enforce the full sweep of the statute, rather than being instances of mere bureaucratic nonfeasance, are responses of conscientious administrators to severe practical problems—of valuation, liquidity, enforcement, and public understanding and acceptance—that would surely follow from attempted full enforcement.[28] The focus of Professors Abreu and Greenstein is limited to issues relating to the definition of gross income; in contrast with this Essay, they do not consider other sorts of administrative deviations from the dictates of the Internal Revenue Code. Nevertheless, the overlap between the subject matter of their article and the subject matter of the current Essay is great, because, as described in Part II, most customary deviations involve in-kind receipts and the definition of gross income.

The disagreement here is not with Professors Abreu and Greenstein's excellent survey of the reasons administrators are drawn to customary deviations, but with their characterization of such deviations not as *nonenforcement* of the statute, but as *interpretations* of it. According to Professors Abreu and Greenstein, the statutory definition of gross income (as glossed by *Glenshaw Glass*) "gives the IRS the flexibility to navigate the shoals of social opinion regarding income taxation, thereby . . . permitting the evolution of a concept of income that serves . . . important values in taxation," including "a variety of noneconomic values."[29] This stretches beyond the breaking

26. Comm'r v. Glenshaw Glass Co., 348 U.S. 426, 431 (1955) (describing certain benefits as taxable because they were "accessions to wealth, clearly realized, and over which the taxpayers have complete dominion").

27. Alice G. Abreu & Richard K. Greenstein, *Defining Income*, 11 FLA. TAX REV. 295 (2011).

28. *See id.* at 333–48.

29. *Id.* at 300.

point the concept of what counts as an interpretation. Nothing in the language or legislative history of § 61, and nothing in *Glenshaw Glass*, suggests (for example) that employee-retained frequent-flier miles are not within the definition of gross income. Moreover, the IRS has never stated that frequent-flier miles are not within the scope of § 61. In fact, the IRS's most significant pronouncement on the topic—its 2002 announcement—implies the opposite when it states that "the IRS has not pursued a tax enforcement program" with respect to frequent-flier miles and notes that "[a]ny future guidance on the taxability of these benefits will be applied prospectively."[30] Thus, far from claiming that its position is an interpretation of the statute, the IRS acknowledges that it is not enforcing the law.

The same is true of a number of other customary deviations. For example, Professors Abreu and Greenstein discuss in some detail the evolution of the IRS's position on the tax treatment of unsolicited free samples.[31] In a 1970 revenue ruling, the IRS stated that a newspaper's book reviewer realized income when he received and retained an unsolicited new copy of a book from its publisher.[32] Later in the same year, the IRS withdrew that ruling and replaced it with a much narrower ruling, holding only that the reviewer was required to include the value of the book in gross income if he donated the book to charity and claimed a deduction for the donation.[33] Professors Abreu and Greenstein characterize the second ruling as indicating that an unsolicited free sample is not within the definition of gross income as long as the taxpayer does not claim a deduction for donating it to charity,[34] but the ruling neither states nor implies any such thing. It says nothing about the taxability or nontaxability of taxpayer-retained free samples—and in fact the analytical portion of the ruling suggests that taxpayer-retained samples would be taxable.[35] Although an informed observer could reasonably conclude from the two 1970 revenue rulings that the IRS had decided not to enforce the

30. I.R.S. Announcement 2002-18, 2002-10 I.R.B. 621.

31. Abreu & Greenstein, *supra* note 27, at 313–19.

32. Rev. Rul. 70-330, 1970-1 C.B. 14.

33. *See* Rev. Rul. 70-498, 1970-2 C.B. 6 (holding that "the value of these [2,500 donated] books is includible in the taxpayer's gross income").

34. *See* Abreu & Greenstein, *supra* note 27, at 317–18 (describing as inconsistent with Revenue Ruling 70-498, 1970-2 C.B. 6, the IRS's indication in a 2006 press release that "swag bags" given to presenters at the Academy Awards ceremony were includible in gross income).

35. *See* Rev. Rul. 70-498, 1970-2 C.B. 6 ("It is well established that gross income is not limited to cash received, but may also include the fair market value of property received.").

taxability of taxpayer-retained samples, nothing in either ruling constitutes an IRS interpretation of the statute as not including such samples within the scope of gross income.

In some cases it is debatable whether an IRS action constitutes interpretation or nonenforcement. One example is the 1957 ruling on turned-down game-show prizes, which baldly states—without the slightest attempt to explain or justify its conclusion—that such prizes are not includible in gross income.[36] Rulings of this sort purport to be based on the statutory definition of gross income, so they are interpretive in a formal sense. Because of their utter failure to explain, however, they are interpretive *only* in a formal sense. In substance, they are no different from an IRS announcement that the Code says one thing, but that the IRS will administer the Code as if it said something else. To describe the analysis-free game-show prize ruling as an interpretation of the Code is to collapse a distinction worth maintaining, between a real—albeit aggressively protaxpayer—interpretation (such as the proposed regulations on qualified accelerated death benefits) and nonenforcement masquerading as interpretation.

There is one more definitional question regarding customary deviations. If a deviation is sufficiently open and notorious (so to speak) for sufficiently long, might it thereby acquire the force of law, in the sense that the tax administrators could not then abandon the deviation and begin to enforce the letter of the law? If so, then customary deviations have a limited lifespan as deviations from the law; once they have lasted long enough, they become the law. Such a story might be told, for example, about the nontaxation of the rental value of owner-occupied housing. Perhaps the tax administrators could have declared in the early years of the income tax that imputed rental value is includible in gross income, but perhaps the courts would not permit that today. The case law supplies no answer to the question of whether deviations eventually become law, for the simple reason that the Treasury Department and the IRS have never abandoned well-established customary deviations (in the absence of

36. Rev. Rul. 57-374, 1957-2 C.B. 69. For additional analysis-free rulings, see, for example, Revenue Ruling 81-209, 1981-2 C.B. 16, which held, without explanation, that a lawyer's client does not realize gross income when interest earned on the client's funds held in the lawyer's trust account is paid to a designated tax-exempt entity pursuant to a program established by the state supreme court, and Revenue Ruling 63-77, 1963-1 C.B. 177, which held, also without explanation, that the reimbursement of the interview-travel expenses of a prospective employee by a prospective employer is not includible in the gross income of the prospective employee.

legislative change), and thus there has never been a context in which the question could be litigated.[37]

There are a few hints in the cases that customary deviations might eventually acquire the force of law. In *Vesco v. Commissioner*,[38] the Tax Court held, despite the absence of any statutory authority for not including the value of free flights for family members in an employee's gross income, that the taxpayer-favorable administrative practice of the IRS "should be applied to petitioner on the same basis as it is applied to other taxpayers."[39] This assumed, however, that the IRS would continue to apply the customary deviation to all other similarly situated taxpayers. The court explicitly stated that it was not deciding whether the IRS could have abandoned the deviation as to all taxpayers: "We do not here determine the validity of respondent's argument if his long-standing position were changed as to all taxpayers."[40]

Zager v. Commissioner[41] is also not quite on point on the question of whether customary deviations eventually acquire the force of law. The IRS claimed that the taxpayers realized gross income as a result of interest-free loans from a corporation they controlled.[42] The IRS's position in the litigation was contrary to a long-standing administrative position.[43] In ruling in the taxpayers' favor, the court opined that "if change is desired, a legislative solution would appear to be more appropriate than a judicial departure."[44] However, the noninclusion of the value of interest-free loans had long been blessed by Tax Court precedent,[45] so the noninclusion was not a

37. The IRS did come close once. In 1978 IRS Commissioner Jerome Kurtz indicated that, if Congress did not soon provide a statutory solution to the problem of taxation of a miscellany of employee fringe benefits, he would direct his agency to begin to enforce the full scope of § 61. *Taxing Perks—If Congress Won't, IRS' Kurtz Will*, FORBES, July 24, 1978, at 20. The threat was never carried out, however. For developments in the taxation of fringe benefits following Kurtz's 1978 threat, see *infra* text accompanying notes 62–66.

38. Vesco v. Comm'r, 39 T.C.M. (CCH) 101 (1979).

39. *Id.* at 130.

40. *Id.*

41. Zager v. Comm'r, 72 T.C. 1009 (1979), *aff'd sub nom.* Martin v. Comm'r, 649 F.2d 1133 (5th Cir. 1981).

42. *Id.*

43. *See id.* at 1012 ("[T]he Government does not dispute that its argument on the merits represents a change of position reflected in the administration of the tax laws.").

44. *Id.* at 1014; *see also* Epstein v. Comm'r, 43 T.C.M. (CCH) 666, 667 (1982) (following *Zager* on this point); Baker v. Comm'r, 75 T.C. 166, 168–70 (1980) (same).

45. *See* Dean v. Comm'r, 35 T.C. 1083, 1090 (1961) ("We have heretofore given full force to interest-free loans for tax purposes, holding that they result in no interest deduction for the

mere administrative deviation (no matter how misguided the precedent).

Of course, the absence of any cases squarely on point is a testament to the staying power of customary deviations. As long as the Treasury Department and the IRS never abandon well-established deviations, the question of whether they have the legal power to do so will continue to be of only theoretical interest.

The above discussion concerns the basic "what" of customary deviations. What about the "why"? A more detailed consideration of the "why" is provided in the next Part, which describes some of the highlights of the historical development of customary deviations. For the moment it is enough to note, as have Professors Abreu and Greenstein, that most customary deviations are not unprincipled administrative frolics.[46] Rather, they are ad hoc responses to serious difficulties with applying the Code as written in certain situations. Consider (once again) the examples of frequent-flier miles and turned-down game-show prizes. The 2002 announcement concerning frequent-flier miles attributes the nonenforcement policy to numerous unresolved "technical and administrative issues . . . , including issues relating to the timing and valuation of income inclusions and the basis for identifying personal use benefits attributable to business (or official) expenditures versus those attributable to personal expenditures."[47] This is no mere fig leaf of an explanation. As commentators have pointed out, the practical problems of taxing frequent-flier miles are truly daunting.[48] Similar concerns underlie a number of other customary deviations.

The story behind the game-show revenue ruling is quite different; that ruling was based more on concerns about fairness than on concerns about administrability. It is a well-established rule that in-kind benefits, if includible in gross income at all, are includible at their fair-market value rather than at their subjective value to the taxpayer-recipient.[49] In the case of a nontransferable benefit, this rule

borrower, nor interest income to the lender. We think it to be equally true that an interest-free loan results in no taxable gain to the borrower . . . ." (citations omitted)).

46. *See* Abreu & Greenstein, *supra* note 27, at 348 (describing the IRS as "tr[ying] to reach the right result: a tax system that is equitable, efficient, and administrable").

47. I.R.S. Announcement 2002-18, 2002-10 I.R.B. 621.

48. *See supra* note 10 and sources cited therein.

49. This rule is, in part, a response to the difficulty or impossibility of administering a tax based on subjective values. *See, e.g.*, Rooney v. Comm'r, 88 T.C. 523, 528 (1987) (taxing barter income at fair-market value rather than at the lower subjective value claimed by the taxpayer);

leads to the possibility that the tax on the fair-market value of a prize could be more than the taxpayer's subjective valuation of the prize—in effect forcing the taxpayer to pay more (in income tax) for the prize than the value of the prize to the taxpayer. To avoid the unfairness of that result without venturing into the uncharted waters of subjective valuation, the IRS issued a technically insupportable revenue ruling allowing a game-show contestant to avoid the tax by declining the prize. Again, the customary deviation is not an administrative frolic. Rather, it is a good-faith administrative response to a real difficulty with strict enforcement of the Code.

II. A HIGHLY SELECTIVE HISTORICAL SURVEY OF CUSTOMARY DEVIATIONS

From the early years of the federal income tax, most customary deviations have been with respect to the statutory definition of gross income. Sometimes by pronouncement and sometimes by inaction, the tax administrators have indicated that they would act as if the statute excluded various sorts of noncash benefits from gross income. Customary deviations with respect to deduction provisions are not unheard of (and a few important recent examples are described below),[50] but the statutory definition of gross income remains to this day the most deviated-from provision. There are two explanations for this overrepresentation of administrative exclusions from gross income in the universe of customary deviations. First, following the statutory dictate with respect to the inclusion of noncash benefits in gross income is inherently challenging for the Treasury and the IRS. Enforcement is difficult (especially when information reporting is not required, as it often is not outside the employment context),[51] problems of valuation and liquidity loom large,[52] and taxation of many in-kind benefits may be nonintuitive and objectionable in the minds of the general public.[53] Second, and of equal importance, is the

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Treas. Reg. § 1.61-21(b)(1) (1989) (requiring that taxable fringe benefits be included in gross income at their fair-market value).

50. *See infra* notes 70–82 and accompanying text.

51. *See* RICHARD SCHMALBECK & LAWRENCE ZELENAK, FEDERAL INCOME TAXATION 78 (3d ed. 2011) (describing the difficulty of enforcement where information reporting is not required).

52. *See, e.g.*, *id.* at 113–14 (discussing the valuation and liquidity problems inherent in taxing in-kind receipts).

53. *See, e.g.*, Lawrence A. Zelenak & Martin J. McMahon, Jr., *Taxing Baseballs and Other Found Property*, 84 TAX NOTES 1299, 1299–1300 (1999) (describing the strongly negative

difference in acceptability between administrative sins of omission and sins of commission. A customary deviation from the definition of gross income is a sin of omission, resulting in the absence of any entry on the return of an affected taxpayer. A customary deviation allowing a statutorily unauthorized deduction (or credit) is a sin of commission, resulting in an incorrect entry on the return of an affected taxpayer. In the former case, the lack of an affirmative act and the literal invisibility of a nonentry result in customary exclusions attracting much less critical attention than customary deductions (or credits) would attract.

In the early decades of the income tax, fringe benefits of employment were an especially rich source of customary deviations from the statutory definition of gross income.[54] Strictly speaking, some of these deviations were not deviations at all under the definition offered above,[55] because they were expressed in official pronouncements which offered explanations for their conclusions. For example, in a 1920 pronouncement the Bureau of Internal Revenue explained that occasional "supper money" paid by an employer to an employee working late "is considered as being paid for the convenience of the employer and for that reason does not represent taxable income to the employee."[56] A year later, the Bureau ruled that gross income did not include the value of free transportation passes issued by a railroad to its employees and their families for nonbusiness use; the passes were "considered gifts and [so] the value thereof does not constitute taxable income to the employees."[57]

At least from the enlightened perspective of 2012, the rationales of both rulings are ludicrous. Nothing in the statutory definition of gross income (then or now) suggests that amounts paid "for the

reaction of politicians—presumably inspired by their sense of public sentiment—to the possibility that a baseball fan would realize gross income from catching a valuable record-breaking home-run baseball).

54. The history of the taxation of fringe benefits offered here is highly selective. More thorough accounts can be found in Wayne M. Gazur, *Assessing Internal Revenue Code Section 132 After Twenty Years*, 25 VA. TAX REV. 977, 980–95 (2006), and in Susan R. Finneran, *Fringe Benefits or "Condition of Employment": Uniformity, Certainty, and Compliance*, 78 NW. U. L. REV. 198, 223–57 (1983).

55. *See supra* text accompanying note 14.

56. O.D. 514, 2 C.B. 90 (1920). The ruling is unusual in its exclusion of cash; the employer's direction that the cash be spent on food puts the "supper money" at the borderline of cash and in-kind benefits.

57. O.D. 946, 4 C.B. 110 (1921).

convenience of the employer" are for that reason outside the boundaries of gross income, and the idea that the railroad passes were gifts rather than part of an employee's compensation package is simply out of touch with reality. Taxpayer-favorable positions based on dubious interpretations of the Code are legitimately distinguishable from customary deviations, but positions based on risible rationales shade into positions with no statutory foundation whatsoever, and thus into the realm of customary deviations.

Although a few other deviations were also set forth in published rulings,[58] for many decades the IRS's routine administrative practice was not to enforce the taxation of many sorts of fringe benefits, despite the absence of published rulings on point. As the government admitted in its brief in a 1962 Supreme Court case, under the IRS's administrative practice fringe benefits were "not generally . . . considered income to the employees even if the employer's sole reason for providing them [was] to confer a benefit upon the employees—*e.g.*, provision of parking facilities, medical services, swimming pools, libraries, courtesy discounts, etc."[59]

In an attempt to impose some order on the tax treatment of miscellaneous fringe benefits (that is, fringe benefits not already covered by a specific exclusion provision of the Code), in 1975 the Treasury Department issued a discussion draft of proposed regulations which would have provided at least a regulatory foundation for some of the de facto administrative exclusions, while putting an end to others.[60] In response to criticism from all sides, the Treasury Department abandoned the proposal the next year.[61]

Congress became involved in 1978. In July of that year, IRS Commissioner Jerome Kurtz took the rather remarkable step of warning that, unless Congress provided a statutory basis for the exclusion of miscellaneous fringe benefits, he would direct his agency

58. *See, e.g.*, O. 1014, 2 C.B. 88, 89–90 (1920) (holding that employer-provided group term life insurance was not included in the gross income of a covered employee); Rev. Rul. 59-58, 1959-1 C.B. 17, 18 (excluding from gross income the value of holiday hams and turkeys received by employees "[i]n view of the small amounts involved, and since it may reasonably be contended in many cases that such items constitute excludable gifts"; the latter explanation implied that in some cases the gift characterization would *not* be reasonable).

59. Brief for the United States at 39, Rudolph v. United States, 370 U.S. 269 (1962) (No. 396).

60. *See* Prop. Treas. Reg. § 1.61-16(a), 40 Fed. Reg. 41,118, 41,119 (Sept. 5, 1975) (listing benefits that are included in and excluded from gross income).

61. Fringe Benefits: Withdrawal of Discussion Draft, 41 Fed. Reg. 56,334, 56,334 (Dec. 28, 1976).

to begin enforcing the taxation of forty types of then-untaxed benefits.[62] Perhaps not coincidentally, three months later Congress imposed a moratorium[63] (which finally expired at the end of 1983, after having been twice extended)[64] on any actions by the Treasury Department or the IRS that would alter the established nontaxation of fringe benefits.

Following the expiration of the moratorium, in early 1984 the IRS announced that it would replace the legislative moratorium with a self-imposed version, but only through the end of 1984.[65] Faced with the possibility that the Treasury Department and the IRS might soon begin enforcing I.R.C. § 61 as written, and perhaps weary of moratorium legislation, Congress finally brought order to the taxation of miscellaneous fringe benefits by enacting new § 132.[66] The new provision furnished a statutory basis for most of the customary deviations that had been established for decades. At the same time, however, Congress added a specific mention of "fringe benefits" in § 61(a)(1) (which lists "compensation for services" as a component of gross income), thus indicating that there were to be no more de facto administrative exclusions for fringe benefits not excluded by § 132.[67]

As a result of the 1984 legislation, the incidence of customary deviations in the fringe-benefit context has been greatly reduced. (The glaring exception is the de facto exclusion of employee-retained frequent-flier miles, if those miles are understood as received by employees from their employers.)[68] Deviations from § 61 remain

62. *See Taxing Perks—If Congress Won't, IRS' Kurtz Will*, *supra* note 37, at 20 (explaining that Kurtz planned to issue whatever directives were necessary to tax fringe benefits).

63. Act of Oct. 7, 1978, Pub. L. No. 95-427, § 1, 92 Stat. 996, 996.

64. Act of Dec. 29, 1979, Pub. L. No. 96-167, § 1, 93 Stat. 1275, 1275; Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, tit. VIII, § 801, 95 Stat. 172, 349.

65. Rev. Proc. 84-14, 1984-1 C.B. 431.

66. Deficit Reduction Act of 1984, Pub. L. No. 98-369, div. A, tit. V, subtit. C, § 531(a), 98 Stat. 494, 877 (codified as amended at I.R.C. § 132 (2006 & Supp. IV 2011)).

67. *Id.* § 531(c), 98 Stat. at 884 (codified at I.R.C. § 61 (2006)).

68. The tax administration problems presented by frequent-flier miles have much in common with the problems presented by the miscellaneous fringe benefits addressed by § 132. Why, then, did Congress also not eliminate the frequent-flier customary exclusion in the 1984 legislation by providing a statutory basis for the exclusion? The answer seems to be that frequent-flier programs were too recent a phenomenon in 1984 for their customary exclusion to have become well established, and thus to have come to the attention of Congress. *See* Paul Grimes, *Practical Traveler: Coupons and Other Bonuses for the Airborne*, N.Y. TIMES, Oct. 11, 1981, § 10, at 3 (describing "bonus incentive plans based on the number of trips you take or miles you fly" recently introduced by many airlines).

significant, however, outside the employment setting; the previously mentioned ruling on turned-down game-show prizes is one example.[69]

Two post-1984 developments involved the expansion of customary deviations beyond the gross-income setting. The first development concerned the deduction for charitable contributions. In the 1989 case of *Hernandez v. Commissioner*,[70] the Supreme Court upheld the IRS's position that Scientologists were not entitled to deduct the "fixed donations"[71] charged by the Church of Scientology for "auditing" services, on the grounds that the "payments were part of a quintessential *quid pro quo* exchange."[72] The Court rejected the taxpayers' arguments that "purely religious" benefits should be disregarded in the quid pro quo analysis and that the IRS impermissibly discriminated against Scientology by denying the charitable deduction to Scientologists while allowing deductions to members of other religions in analogous circumstances.[73] Only four years after the Court decided *Hernandez*, the IRS issued an analysis-free one-sentence revenue ruling announcing that the 1978 ruling denying a deduction for Scientology auditing payments was thereby "obsoleted,"[74] implying that the IRS would no longer challenge the deduction claims of Scientologists. But for the *Hernandez* decision, the IRS's new protaxpayer position might have been characterized as a debatable-on-the-merits interpretation of the statute, but in the aftermath of the Court's authoritative interpretation of the statute the new position constituted a deviation—unusual for being a deviation from a deduction provision rather than from § 61.

More recently, the tax administrators have announced deviations of great economic significance in another setting far removed from § 61. Section 382 of the Code imposes strict limits on the deductibility

69. *See* Rev. Rul. 57-374, 1957-2 C.B. 69 (stating that when an individual refuses to accept an all-expense-paid vacation, the value of the trip is not included in gross income); *see also, e.g.*, Rev. Rul. 81-209, 1981-2 C.B. 16, 17 (holding that a lawyer's client does not realize gross income when interest earned on the client's funds held in the lawyer's trust account is paid to a designated tax-exempt entity pursuant to a program established by the state supreme court); Rev. Rul. 63-177, 1963-1 C.B. 177, 178 (holding that a prospective employer's reimbursements to individuals for interview expenses are not includible in gross income). All three rulings are still in force.

70. Hernandez v. Comm'r, 490 U.S. 680 (1989).

71. *Id.* at 685.

72. *Id.* at 691.

73. *See id.* at 689–94 (discussing quid pro quo); *id.* at 700–03 (discussing disparate treatment).

74. Rev. Rul. 93-73, 1993-2 C.B. 75.

of corporate net-operating-loss carryforwards and of unrealized built-in losses, following either an acquisition of a loss corporation by another corporation or a major change in the ownership of a loss corporation. In September 2008, as Congress was considering a massive bailout bill for the financial industry, the IRS of the Bush administration made its own contribution to the bailout effort by issuing Notice 2008-83,[75] declaring—without making any attempt to explain or justify its conclusion—that the § 382 limitations on the use of built-in losses following an ownership change would no longer apply to banks.[76] The primary purpose of the notice appears to have been the facilitation of the acquisition of failing Wachovia—by Wells Fargo, as it turned out. Although the notice generated considerable outrage in the media, among tax experts, and on Capitol Hill,[77] it achieved the desired result. Early in 2009, Congress took the highly unusual step of enacting legislation specifically disapproving of Notice 2008-83 as "inconsistent with the congressional intent" and describing the legal authority for the notice as "doubtful."[78] The legislation, however, also declared that taxpayers could rely on the notice with respect to ownership changes occurring before January 17, 2009.[79]

The Obama administration followed the Bush-era precedent, thus making protaxpayer administrative revisions of § 382 a bipartisan activity. The Obama-era IRS issued several § 382 notices of its own, including, most prominently, Notice 2010-2,[80] which declared—again, without apparent support from the statute—that § 382 would not be triggered if the Treasury Department were to sell its shares of General Motors to the public.[81] Although the notice attracted some sharp criticism,[82] it remains in effect.

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75. I.R.S. Notice 2008-83, 2008-2 C.B. 905.

76. *Id.*

77. For a review of some of the reactions to the notice, see Lawrence Zelenak, *Can Obama's IRS Retroactively Revoke Massive Bank Giveaway?*, 122 TAX NOTES 889, 889–93 (2009).

78. American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, div. B, tit. I, subtit. C, pt. VII, § 1261(a)(2)–(3), 123 Stat. 115, 343.

79. *Id.* § 1261(b)(1)(A), 123 Stat. at 343.

80. I.R.S. Notice 2010-2, 2010-1 C.B. 251.

81. *Id.* at 252. The notice did not mention General Motors by name.

82. *See, e.g.*, J. Mark Ramseyer & Eric B. Rasmusen, *Can the Treasury Exempt Its Own Companies from Tax? The $45 Billion GM NOL Carryforward*, 1 CATO PAPERS ON PUB. POL'Y 1, 5 (2011) (characterizing the ruling as an unauthorized gift from the Obama administration to the United Auto Workers).

The recent § 382 notices should be troubling to anyone who values the application of the rule of law to tax administration. One can only speculate, but it is plausible that the § 382 notices never would have been issued but for the precedent of the § 61 customary deviations. Although the § 61 deviations are considerably easier to defend on the merits than the § 382 notices, both the Bush and Obama administrations may have taken the § 61 deviations to stand for the proposition that the Treasury Department and the IRS are always free to disregard the dictates of the Internal Revenue Code, as long as they do so in a taxpayer-favorable direction.

Whether it is possible to combine the genuine administrative advantages of the restrained use of customary deviations with respect for the rule of law is considered in the next section.

III. THE ABSENCE OF THIRD-PARTY STANDING, THE SURVIVAL OF CUSTOMARY DEVIATIONS, THE RULE OF LAW, AND A DIFFERENT APPROACH

When the IRS signals that it is not going to enforce the provisions of the Internal Revenue Code in a particular context—be it employee-retained frequent-flier miles or Wells Fargo's acquisition of Wachovia's built-in losses—there is usually no lack of good-government sorts who are offended by the IRS's position and who would be only too happy to challenge that position in court on behalf of the public.[83] Intermeddling law professors alone (possibly including this one) would be sufficient to challenge most of the more significant customary deviations. Very few such suits are brought, however, and none succeed, because the law of standing does not permit self-appointed guardians of the public interest to challenge the IRS's unduly lenient treatment of other taxpayers. Concurring in 1976 in a leading case rejecting a claim of third-party standing, Justice Stewart remarked that he could not "imagine a case, at least outside the First Amendment area, where a person whose own tax liability was not affected ever could have standing to litigate the federal tax liability of someone else."[84]

83. For expressions of dissatisfaction with those particular nonenforcement decisions, see Dodge, *supra* note 10, at 1301; Ramseyer & Rasmusen *supra* note 82, at 5; Zelenak, *supra* note 77, at 889.

84. Simon v. E. Ky. Welfare Rights Org., 426 U.S. 26, 46 (1976) (Stewart, J., concurring). For additional examples of the Supreme Court denying third-party standing in tax cases, see *Allen v. Wright*, 468 U.S. 737, 740 (1984), which involved a third-party challenge to federal

It is conceivable that a taxpayer whose own tax liability was at issue—and who thus clearly had standing—would want to challenge a generally taxpayer-favorable administrative deviation from the statute.[85] Suppose, for example, a book reviewer receives free review copies from publishers in year one, and (in keeping with the IRS's well-established nonenforcement policy with respect to unsolicited books not later claimed as charitable deductions)[86] does not include the value of the books in his gross income on his income tax return for year one. In year five the reviewer sells the copies for some nontrivial amount. He reports no gain on the sale, claiming he has a basis in the books equal to the value he should have reported on his return for year one—a year which is now, conveniently enough,

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income tax exemptions for racially segregated schools, and *DaimlerChrysler Corp. v. Cuno*, 547 U.S. 332, 340–46 (2006), which involved third-party challenges in federal court to state and local tax breaks.

As hinted at by Justice Stewart, special considerations apply in the First Amendment context. Under *Flast v. Cohen*, 392 U.S. 83 (1968), one's status as a taxpayer gives one standing to challenge government expenditures benefitting religion as violations of the Establishment Clause, *id.* at 88. Thus, under *Flast* one taxpayer might have had standing to challenge statutorily unauthorized favorable IRS treatment of another taxpayer as a violation of the First Amendment. At its broadest, this was a very narrow exception to the no-third-party-tax-standing rule, but two recent Supreme Court decisions have narrowed *Flast* to the point of nonexistence in this context. In *Hein v. Freedom from Religion Foundation*, 551 U.S. 587 (2007), the Court declined to "lower[] the taxpayer standing bar to permit challenges of purely executive actions," *id.* at 611. In the immediate aftermath of *Hein*, it appeared that a taxpayer would have standing to challenge the First Amendment acceptability of the *statutory* treatment of another taxpayer, but not to challenge the favorable *administrative* treatment (in contravention of the statute) of another taxpayer. *Hein* alone would have been sufficient to deny *Flast* standing in any suit challenging the constitutionality of a customary deviation from the Code. The Court limited *Flast* again in *Arizona Christian School Tuition Organization v. Winn*, 131 S. Ct. 1436, 1440 (2011), in which the Court held that tax credits (under the Arizona state income tax) did not count as government spending, and so could not be challenged by a third party claiming standing under *Flast*. Even apart from *Hein*, *Arizona Christian School Tuition Organization* would be sufficient to deny standing to taxpayers challenging the constitutionality of favorable IRS treatment of other taxpayers. Thus, the sort of third-party standing hinted at by Justice Stewart in First Amendment cases now appears to be doubly foreclosed.

85. *See* Gregg D. Polsky, *Can Treasury Overrule the Supreme Court?*, 84 B.U. L. REV. 185, 239–43 (2004) (hypothesizing a number of situations in which taxpayers might be motivated to challenge the validity of the so-called "check-the-box" regulations governing tax classification of entities as partnerships or corporations, despite the generally taxpayer-favorable character of the regulations).

86. *See supra* notes 32–34 and accompanying text. As explained in that text, the nonenforcement policy may be implied by Revenue Ruling 70-498, 1970-2 C.B. 6, when read in the context of the earlier ruling it replaced, but the IRS has never formally stated this nonenforcement policy.

closed by the three-year statute of limitations.[87] His argument is that, although his failure to report the value of the books in year one was consistent with the IRS's customary deviation from the statute, the customary deviation is itself without legal foundation.[88]

The attractiveness to taxpayers of this sort of scheme is severely curtailed by §§ 1311 through 1314 of the Code, which provide for "mitigation" of the statute of limitations in various situations in which the taxpayer (or the IRS) takes a position on the tax treatment of a transaction in an open year that is inconsistent with the treatment of a related transaction in a year now closed by the statute of limitations.[89] In situations such as the example—in which a taxpayer claims basis on account of an amount he should have included in gross income in a closed year—the taxpayer is allowed the claimed basis if the taxpayer's position is substantively correct, but the IRS is allowed to assess and collect the additional earlier-year tax that would be produced by the inclusion in that year, despite the fact that the earlier year is otherwise closed.[90]

Although the mitigation provisions very often eliminate the incentive for taxpayers to challenge protaxpayer customary deviations in closed years to gain an advantage in later open years, this will not always be the case. In the book-reviewer example, if the applicable tax rate in the later year is higher than the applicable tax rate in the earlier year, then the benefit of the additional basis in the later year will be greater than the cost of the inclusion in the earlier year. The reviewer would then have motivation to challenge the protaxpayer customary deviation in the earlier year, despite the fact that a successful challenge would bring into play the mitigation provisions.

Despite the theoretical possibility that a taxpayer could have motivation—and standing—to challenge the application to himself of a taxpayer-favorable customary deviation, in practice such litigation is

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87. *See* I.R.C. § 6501(a) (Supp. IV 2011) (providing for a three-year statute of limitations).

88. For an unsuccessful taxpayer effort along similar lines, see *Woodsam Associates v. Commissioner*, 198 F.2d 357, 359 (2d Cir. 1952). In keeping with the long-standing IRS interpretation of the statute—not a mere customary deviation—the taxpayer did not treat nonrecourse borrowing against unrealized appreciation as a taxable event; in a later year, however, the taxpayer claimed an increase in the basis of the mortgaged property on the grounds that the borrowing was, in fact, a taxable event. *Id.* at 359.

89. I.R.C. §§ 1311–1314 (2006).

90. *See id.* § 1312(7) (including situations of this sort in the list of circumstances giving rise to mitigating adjustments under § 1311).

vanishingly rare.[91] As a result, the prospect of such litigation has had no discernible braking effect on the IRS's customary-deviation practices.[92]

This Essay does not attempt to set forth a full-blown argument that customary deviations are often appropriate or even necessary administrative responses to the severe difficulties that would arise if the IRS insisted on enforcing the full letter of the law in all situations—although even my brief descriptions of the frequent-flier mile and game-show prize issues may be enough to make the point in a nonrigorous sort of way.[93] If the point is accepted, however, it follows that the denial of third-party standing in tax cases is a very good thing. After all, customary deviations could not survive in their current form under a legal regime which conferred standing upon any third party objecting to a customary deviation benefitting other taxpayers.[94] The IRS could not, for example, suggest that employee-retained frequent-flier miles are includible in gross income under the terms of § 61, but then indicate that it is going to act as if they were not, and signal to taxpayers with a wink and a nod that taxpayers should follow the IRS's lead. Similarly, the IRS could not simply announce—without making any attempt to reconcile its announcement with the dictates of the statute—that it was going to administer the § 382 restrictions on trafficking in tax losses as if that provision contained exceptions for Wells Fargo and General Motors.

91. *Woodsam* is one of the few cases that might be cited as such a challenge. *See Woodsam*, 198 F.2d at 358–59. Strictly speaking, however, even it is not such a challenge because the challenged protaxpayer treatment was not, in fact, a deviation from the statute. *See id.* at 359 (holding that the taxpayer's borrowings "did not change the basis for the computation of gain or loss").

92. Even if a taxpayer were to mount a successful challenge to a particular deviation, the litigation would likely have little or no effect on the application of the challenged deviation to other taxpayers. If the IRS prefers not to enforce the law on the books in a particular context, the mere existence of a judicial opinion (even if it is from the Supreme Court) does not compel the IRS to abandon its nonenforcement policy with respect to any taxpayer other than the taxpayer involved in the litigation. As always, the absence of third-party standing leaves the IRS free to pursue a policy of nonenforcement. And because the effect of the nonenforcement policy is overwhelmingly taxpayer favorable, other taxpayers will not be lining up to take advantage of the judicial precedent.

93. For a much more ambitious—and largely successful—defense of the IRS practice of often ignoring the letter of the law with respect to the inclusion of in-kind benefits in gross income, see Abreu & Greenstein, *supra* note 27, at 299.

94. *See* Polsky, *supra* note 85, at 245 (remarking, after arguing against the validity of the generally taxpayer-favorable check-the-box entity classification regulations, "[i]t is likely that the restrictive taxpayer standing doctrine plays a role in the Treasury's issuance of these invalid rules").

Nor could the IRS make stick its analysis-free revenue rulings holding that various items—turned-down game-show prizes, for example—are not includible in gross income. In all these situations, if third-party standing existed courts would likely feel compelled to apply the Code as written, giving little or no weight to the various "soft" policy arguments in favor of the deviations.

Although the denial of third-party standing gives the Treasury Department and the IRS the flexibility they arguably need, it creates serious rule-of-law problems. To anyone who takes the rule of law seriously, it is troubling to contemplate that the Treasury and the IRS are almost unconstrained in their ability to make de facto revisions to the Internal Revenue Code enacted by Congress, as long as those revisions are in a taxpayer-favorable direction. It is especially troubling to think that the relatively innocent customary deviations in the gross income context may have bred a disrespect for the rule of law on the part of the Treasury and the IRS, so that tax administrators now believe they have the power and the authority to disregard *any* Code section when doing so would further their notion (*not* Congress's notion) of good tax policy. The recent selective disregardings of § 382 by the Bush and Obama administrations are bad enough from a rule-of-law perspective,[95] and may be signs of even worse to come. It may seem, then, that the choice is between the unsatisfactory alternatives of a system that denies crucial flexibility to tax administrators or a system that fosters a deep disrespect for the rule of law.

But there may be a way to preserve needed administrative flexibility while paying more respect to rule-of-law concerns.

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95. Professors Mark Ramseyer and Eric Rasmusen are particularly scathing on the rule-of-law implications of the 2010 notice declaring (to oversimplify a bit) that § 382 did not apply to General Motors. According to them, there would have been no substantive difference between the actual notice and a more honest hypothetical alternative stating that President Obama "is grateful to the UAW for the assistance it provided his party," and that "[i]n gratitude for that political support, the Treasury announces that" § 382 does not apply to General Motors. Ramseyer & Rasmusen, *supra* note 82, at 30.

In response to what they view as the scandal of the § 382 notices, Ramseyer and Rasmusen propose a statute giving any two members of Congress standing to challenge any taxpayer-favorable "arbitrary and capricious" tax administrative position, with the "arbitrary and capricious" standard satisfied when the "statute is unambiguously contrary to the Treasury position." *Id.* at 37. The proposal has considerable merit in the context of the § 382 notices, but Ramseyer and Rasmusen do not consider its impact outside of that context. Their proposal would grant any two members of Congress standing to challenge (for example) the IRS announcement that it would not enforce the taxation of frequent-flier miles, thereby denying the IRS flexibility which is arguably appropriate or even crucial in that context.

Congress, the Treasury Department, and the IRS could take steps to preserve the ability of tax administrators to deviate from strict adherence to the statute in situations in which deviations are a reasonable response to concerns of administrability—broadly defined to include, among other things, problems of valuation, liquidity, timing, enforcement, and public understanding and acceptance. Given that the large majority of customary deviations involve the noninclusion in gross income of various types of nonemployee non-cash benefits, perhaps the best approach would be for Congress to enact a new Code provision specifically authorizing the Treasury Department to issue regulations narrowing the statutory definition of gross income with respect to non-cash benefits received outside of an employment context, whenever the IRS decides that administrative concerns make such a narrowing advisable.[96] If this approach worked well in the gross-income context, Congress might decide to give the Treasury Department similar authority to revise by regulation other specified Code sections—although it is hard to imagine that Congress would ever decide that it was appropriate (for example) to give Treasury the authority to "turn off" § 382 for certain taxpayers.

Armed with an explicit grant of authority, the Treasury Department could replace its unacknowledged deviations, its announcements that it will not enforce the law, and its analysis-free revenue rulings with what would then be clearly authorized regulations narrowing the scope of gross income—and perhaps other clearly authorized regulations revising other Code sections pursuant to other express grants of authority. Needed administrative flexibility would be maintained, and respect for the rule of law would be enhanced. No longer would a de facto administrative exclusion for frequent-flier miles foster an administrative mindset in which the Treasury Department feels free to issue notices conferring billions of dollars of unauthorized tax benefits on a small number of clearly identifiable taxpayers.

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96. Such a provision would not unambiguously confer on the Treasury Department authority to issue regulations excluding from gross income employee-retained frequent-flier miles, since the miles are at least arguably received by employees from their employers (on the view that there is a constructive transfer of the miles from employer to employee when the employer allows the employee to retain the miles rather than declining them or turning them over to the employer). In any event, the question of the tax status of frequent-flier miles is sufficiently high profile and of sufficient economic importance that Congress should probably resolve it by statute (following the 1984 precedent of the miscellaneous fringe benefit rules, *see supra* notes 65–66 and accompanying text) rather than leaving it to administrative discretion.

An alternative approach, suggested by Commissioner Kurtz's 1978 threat to start enforcing the letter of the law with respect to fringe benefits,[97] would be for the tax administrators to notify Congress that a statutorily unauthorized customary deviation has been identified, and that unless Congress quickly provides a statutory foundation for the current practice, the administrators intend to end the deviation and start enforcing the law on the books at a specified date in the fairly near future. Even if this game of chicken happened to work in the case of Kurtz's threat,[98] it is not satisfactory as a general solution. First, it could never be truly institutionalized, because each succeeding administration would be free to use or not use this approach. Second, in many cases a reasonable date to begin enforcing the law on the books would be after the departure of the current administration, in which case the threat could not credibly be made. Third, if the reason for the existence of the deviation is the extreme unworkability of strict enforcement (as is arguably the case with frequent-flier miles), then the threat of full enforcement might not be credible even apart from concerns about the life expectancy of the current administration. Finally, even if the threat is credible, the political barriers to the enactment of tax legislation—even of noncontroversial provisions—are sometimes so high that the threat may fail to produce a legislative solution despite overwhelming congressional sentiment in favor of a solution. Because none of these objections apply to the alternative approach of a statutory grant of authority to the Treasury Department to issue deviating regulations, the statutory authority approach is preferable to the game-of-chicken strategy.

CONCLUSION

Customary deviations from the statute in the administration of the federal income tax have existed almost as long as there has been a federal income tax. Especially in the administration of the definition of gross income, there are strong arguments of administrative convenience—or even necessity—in favor of many of the deviations. Although such deviations have always been in tension with the rule of law, that tension may have been tolerable as long as tax

97. *Taxing Perks—If Congress Won't, IRS' Kurtz Will*, *supra* note 37, at 20.

98. The enactment of § 132 followed six years after the threat. Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 531(a), div. A, tit. V, subtit. C, 98 Stat. 494, 877 (codified as amended at I.R.C. § 132 (2006 & Supp. IV 2011)). But it is not clear that the threat caused the enactment.

administrators exercised self-restraint in their use of customary deviations. The recent bipartisan extension of deviations to the loss-trafficking context suggests a serious eroding of administrative self-restraint and a greater threat to the rule of law. The time may have come for Congress to intervene by providing explicit statutory authorization for some deviations (primarily or exclusively deviations relating to the definition of gross income) while making clear the unacceptability of deviations in other contexts.

It is a commonplace that nonenforcement (or severe underenforcement) of one law may breed among the citizenry a general disrespect for the law. That was, for example, one of the standard critiques of the underenforcement of Prohibition laws,[99] and it is today a common Tea Party critique of the Obama administration's allegedly lax enforcement of the immigration laws.[100] This is also a concern in the tax context; for example, the ability of tipped workers to avoid paying tax on a substantial portion of their tips may contribute to a general decline in voluntary compliance.[101]

The customary deviations discussed in this Essay, however, raise a different concern. Because the taxpaying public may not understand that customary deviations are contrary to law—for example, most taxpayers may assume that the Code excludes frequent-flier miles from gross income—customary deviations may do little or nothing to foster a general disrespect for the income tax among the citizenry. The mischief of customary deviations is in their effect on the tax administrators. As the example of the recent § 382 announcements suggests, customary deviations may have contributed to an insufficient respect for the dictates of the Code on the part of high-level Treasury Department and IRS officials. Although this Essay has considered only customary deviations in the administration of the federal income tax, scholars of other federal agencies—the SEC and the EPA come readily to mind—might profitably investigate whether

99. *See, e.g.*, DANIEL OKRENT, LAST CALL: THE RISE AND FALL OF PROHIBITION 316 (2010) (describing and quoting President Herbert Hoover's inaugural address, in which Hoover stated that underenforcement of Prohibition laws by state and local authorities was "destroy[ing] respect for all law").

100. *See, e.g.*, Alberto R. Gonzales, *"Anchor Babies" Aren't the Problem with Immigration*, WASH. POST, Aug. 22, 2010, at B2 (claiming that the Obama administration had failed to enforce the immigration laws and that this failure "breeds . . . disrespect for the rule of law").

101. *See, e.g.*, SCHMALBECK & ZELENAK, *supra* note 51, at 52 ("[T]he existence of unenforced rules may foster a general disrespect for the tax system, and thus encourage cheating not only with respect to tips but whenever cheating is not likely to be detected.").

customary deviations play a similar role—and raise similar concerns—in the practices of those agencies.