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ALJs in State-Local Tax Cases: To Whom Is Deference Due?

Steve R. Johnson
Florida State University College of Law

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by Steve R. Johnson

This installment of the column reports on an interesting recent Nevada sales tax case, *State Dep't of Taxation v. Masco Builder Cabinet Group*.[1] The case involved two issues: (1) whether the Department of Taxation gave appropriate deference to the findings and conclusions of the administrative law judge who had originally heard the case, and (2) whether the principle of equitable tolling applied to extend the statute of limitations period for the taxpayer's refund claims. The taxpayer, represented by attorney Brett Whipple, prevailed in the Nevada Supreme Court on both issues.[2]

The first part below develops the facts of *Masco*. The second part addresses the deference issue. The third part considers the equitable tolling issue.

Facts of *Masco*

Masco is a nationwide cabinet manufacturing company that sells its cabinets in retail showrooms. It also installs cabinets in houses under construction contracts.

For Nevada sales tax purposes, those two commercial operations have different effects. Masco was obligated to remit sales tax for each retail sale and to remit use tax for each construction contract.[3] The sales tax and the use tax are calculated on the same rate. However, sales tax is computed as a percentage of the retail sales price of Masco's cabinets, while use tax is computed as a percentage of Masco's cost to acquire the components of the cabinets.[4] Accordingly, it is better, from a tax standpoint, for Masco to enter into a construction contract than to make a retail sale.

In 2003 Masco acquired Root Industries, a Nevada company engaged largely in retail sales of cabinets. Masco kept Root personnel and Root's computer system and accounting programs, which had been designed for a retail sales operation. When the accounting program generated invoices to send to retail customers, it automatically added tax labeled as "sales tax."

However, under the construction contracts, Masco's customers agreed to pay Masco a lump sum in exchange for Masco's provision and installation of the cabinets, and Masco agreed to be responsible for paying any taxes. As a result, when former Root personnel generated invoices for the lump-sum contracts, they had to "back into" the contract price so that the invoice total equaled the agreed-on lump sum.

In 2006 the Nevada Department of Taxation began an audit of Masco for periods from May 2003 to April 2006. During the audit, the above accounting procedures were discovered, and Masco and the department's auditor agreed that the Root operation arguably had been paying sales tax on the construction contracts when it should have been paying use tax instead. "The auditor and Masco agreed preliminarily that Masco might be entitled to a refund for the amount it arguably overpaid and that the auditor would consider the issue of Masco's potential refund within the overall context of his audit."[5]

Three-year limitations periods exist in Nevada for both a taxpayer making claim for refund of an overpayment[6] and the department assessing a deficiency.[7] Because it was expected that the audit would be lengthy, the department asked Masco to

[1]265 P.3d 666 (Nev. 2011) (per curiam).

[2]The author consulted with Whipple on this case. All information appearing in this column is drawn from the reported decision and other public sources.

[3]Nev. Rev. Stat. 372.105 and 372.185; Nev. Admin. Code 372.200 (1).

[4]*Id.*

[5]265 P.3d at 668.

[6]Nev. Rev. Stat. 372.635(1) and 372.650.

[7]Nev. Rev. Stat. 360.355(1).

execute a waiver of the assessment limitations period. "Having agreed with the auditor that its refund request would be dealt with in the context of the audit," Masco signed the waiver "with the understanding that the waiver would also maintain the timelines of its own refund request. . . . Based upon this understanding, Masco did not file a formal refund claim."[8]

The audit was completed by August 2007. The auditor left the department without telling Masco of his departure and without informing Masco that the audit had been completed. Masco tried to contact the department, but its calls were not returned. In October 2007, after the waiver had expired, Masco was able to speak with the new auditor, who stated that Masco's refund request was being denied.

In December 2007 Masco received a deficiency assessment from the department. Masco filed a petition for redetermination of the deficiency and a formal claim for refund. At the ensuing hearing before an ALJ, the department argued that substantively Masco had been acting as a retail seller (not as a construction contractor) under the relevant contracts and that procedurally the refund claim was time barred in part.

The ALJ held for Masco on both issues. The ALJ found that the contracts were construction, not retail, contracts and thus that Masco had mistakenly overpaid sales tax. The ALJ also concluded that Masco's late filing of the formal refund claim was excused because Masco had reasonably relied on the first auditor's assurance that Masco's refund request would be considered within the overall context of the audit.

The department appealed the ALJ's determinations to the State Tax Commission. The commission reversed both of the ALJ's determinations. The district court reversed the commission and reinstated the ALJ's determinations. The Nevada Supreme Court affirmed.

Deference Issue

This column recently engaged in exploration of when state courts afford deference to the decisions of state and local tax administrators.[9] In *Masco*, the courts reviewed a decision by the State Tax Commission reversing a decision by the ALJ. *Masco* thus raises the important question: To whom — to which actor in the system of tax administration — do the courts owe deference?

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Below I lay the groundwork for analyzing that question by describing the use of ALJs at the federal and state levels. Then, I turn to how *Masco* answered the question.

Federal ALJs

Procedures used by federal agencies to adjudicate cases are diverse. The federal Administrative Procedure Act (APA) prescribes procedures to be used in so-called formal adjudications.[10] Typically, those adjudications are conducted by ALJs. Federal ALJs are appointed through a professional merit selection process, may not be assigned duties inconsistent with their judicial activities, and may be removed or disciplined only for good cause.[11]

The ALJ conducts the hearing and, depending on the dictates of the agency's enabling act, renders either an initial or a recommended decision. An initial decision automatically becomes the decision of the agency unless it is reviewed by a higher level within the agency. A recommended decision must be acted on by the higher level before it can come into effect.

ALJs are crucial to the work of many federal agencies, but not the IRS. The IRS has no substantive adjudicatory power, so it does not use ALJs as part of a process of determining tax liability.[12]

State ALJs

States, too, typically have APAs. The National Conference of Commissioners on Uniform State Laws developed a Model State Administrative Procedure Act (MSAPA) in 1946 and revised it in 1961, 1981, and 2010. Most state APAs are based in part or

[8]265 P.3d at 668.

[9]Steve R. Johnson, "Judicial Deference to State Tax Agencies — An Overview," *State Tax Notes*, Nov. 29, 2010, p. 633, *Doc 2010-24563*, or *2010 STT 228-2*; Johnson, "*Chevron* Deference to State Tax Agencies," *State Tax Notes*, Jan. 24, 2011, p. 285, *Doc 2010-27202*, or *2011 STT 15-2*; Johnson, "Deference — Questions of Fact Versus Issues of Law," *State Tax Notes*, Mar. 21, 2011, p. 883, *Doc 2011-3129*, or *2011 STT 54-2*; Johnson, "Conditional Deference to Tax Authorities," *State Tax Notes*, Apr. 25, 2011, p. 269, *Doc 2011-7239*, or *2011 STT 79-5*; Johnson, "Deference to Tax Agencies' Interpretation of Their Regulations," *State Tax Notes,* May 30, 2011, p. 665, *Doc 2011-9625*, or *2011 STT 104-4*; Johnson, "New Light on *Auer*/*Seminole Rock* Deference," *State Tax Notes,* Aug. 15, 2011, p. 441, *Doc 2011-15272*, or *2011 STT 157-1*.

(Footnote continued in next column.)

[10]*See* 5 U.S.C. sections 554, 555, 556, and 557. Informal adjudications are subject to lesser statutory safeguards (section 555 only), but minimum standards of fairness and procedural regularity are protected by the due process component of the Fifth Amendment. Moreover, agency rules often afford protections not mandated by statute.

[11]5 U.S.C. sections 3105, 5372, and 7521.

[12]ALJs are used, however, to conduct hearings and render decisions in cases in which the government seeks to discipline practitioners before the IRS for violation of the professionalism requirements set out in Treasury Circular 230.

in whole on either the 1961 version or the 1981 version of the MSAPA.[13] A substantial literature now exists on the use of ALJs under state APAs, both generally[14] and for particular states.[15]

The current (2010) version of the MSAPA contemplates that the presiding officer in an agency adjudication must be an ALJ (unless the agency head presides, or designates another presiding officer)[16] and that the ALJ will issue a recommended order or an initial order.[17]

Unlike the IRS, state and local revenue authorities often do have adjudicatory power, although it is subject to judicial review. ALJs or cognate officials often are used by state and local tax departments to conduct initial examinations and render decisions.[18]

Spectrums of Deference

Masco exemplifies controversies in which an ALJ's decision is reviewed by a higher level of the revenue authority, whose decision in turn is reviewed by the courts. The installments of this column cited in note 9 establish that there is a spectrum of judicial deference to the decisions of tax administrators, ranging from *de novo* review (no deference) to various shades of considerable deference.

But *Masco*-type cases implicate a second dimension. If deference is to be shown by the courts to tax agency decisions, where does that deference attach when the agency is divided (that is, when the agency's ALJ and the agency's higher level have reached conflicting conclusions)? In other words, to what degree is the role of a deferential court to see to it that the agency has shown due regard for the ALJ's decision?[19]

Regarding that question, too, a spectrum of views exists. One polar position is that the ALJ who heard the evidence is in the best position to decide the case, thus that the courts should allow reversal by the agency only when the ALJ's decision is clearly wrong. The other polar position would be that the highest relevant authority in the agency is the one who properly speaks for the agency, thus that the courts should intervene to protect the ALJ's contrary resolution only in rare and clear cases.

Where one thinks the right answer lays along this spectrum depends in part on the balance that exists between fact-finding and lawmaking in agency adjudications. To the extent that the case is purely factual, the ALJ's superior exposure to the facts may grow in importance.[20] To the extent that policy judgments and policy promulgation are implicated in the adjudication, the superior political accountability of higher levels of the agency becomes weightier.[21]

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How do the various jurisdictions balance these considerations? At the federal level, the APA provides that agency heads are not compelled to defer to ALJs in the fashion that appellate courts typically

[13]*See generally* Jim Rossi, "Politics, Institutions, and Administrative Procedure: What Exactly Do We Know from the Empirical Study of State Level APAs, and What More Can We Learn?" 58 *Admin. L. Rev.* 961 (2006).

[14]*See, e.g.*, James F. Flanagan, "An Update on Developments in Central Panels and ALJ Final Order Authority," 38 *Ind. L. Rev.* 401 (2005) (hereafter "Flanagan II"); James F. Flanagan, "Redefining the Role of the State Administrative Law Judge: Central Panels and Their Impact on State ALJ Authority and Standards of Agency Review," 54 *Admin. L. Rev.* 1355 (2002) (hereafter "Flanagan I"); Jim Rossi, "Final, but Often Fallible: Recognizing Problems with ALJ Finality," 56 *Admin. L. Rev.* 53 (2004).

[15]*See, e.g.*, Ron Beal, "The Texas State Office of Administrative Hearings: Establishing Independent Adjudicators in Contested Case Proceedings While Preserving the Power of Institutional Decision-Making," 25 *J. Nat'l Ass'n Admin. L. Judges* 119 (2005); F. Scott Boyd, "Florida's ALJs: Maintaining a Different Balance," 24 *J. Nat'l Ass'n Admin. L. Judges* 175 (2004); Jeff S. Masin, "New Jersey's Office of Administrative Law: The Importance of Initial Choices," 23 *J. Nat'l Ass'n Admin. L. Judges* 387 (2003); Frank Sullivan Jr., "Some Questions to Consider Before Indiana Creates a Centralized Office of Administrative Hearings," 38 *Ind. L. Rev.* 389 (2005); Ann Wise, "Louisiana's Division of Administrative Law: An Independent Administrative Hearings Tribunal," 30 *J. Nat'l Ass'n Admin. L. Judiciary* 95 (2010).

[16]MSAPA section 402(a).

[17]MSAPA section 413(b).

[18]*See, e.g., State Dep't of Revenue v. Boyd Bros. Transp., Inc.,* 56 50. 3d 701 (Ala. App. 2010); *Felten Truck Line, Inc. v. State Bd. of Tax Appeals,* 327 P.2d 836, 839 (Kan. 1958); *South Carolina Dep't of Revenue v. Blue Moon of Newberry, Inc.,* _____ S.E.2d _____, 2012 WL 1111410 (S. Car. Apr. 4, 2012).

[19]"The most difficult problem facing the reviewing court arises when, as in this case, the [agency] and the administrative law judge disagree on the facts." *Penasquitos Village, Inc. v. NLRB*, 565 F.2d 1074, 1076 (9th Cir. 1977).

[20]*See, e.g., Amco Elec. v. NLRB*, 358 F.2d 370, 373 (9th Cir. 1966). ("While [an agency] is not bound by the credibility determinations of the trial examiner, nevertheless the probative weight which may be properly given to testimony is severely reduced when an impartial experienced examiner who has observed the witnesses and lived with the case has drawn different conclusions.").

[21]*See, e.g.,* Flanagan II, *supra* note 14, at 402 (expressing the view that "ALJ finality has significant disadvantages. . . . [I]t creates a loss of political accountability . . . and also adversely affects the agency's ability to develop and implement a consistent regulatory scheme").

do to trial courts' findings of fact.[22] Many states take the same tack. However, there is a trend — although it still represents only a minority position — in the direction of states giving ALJs "de jure or de facto authority to make the final agency decision, subject only to judicial review."[23]

Deference in *Masco*

The Nevada Supreme Court's decision to reinstate the ALJ's decision in favor of the taxpayer rested on two planks: (1) the State Tax Commission was obligated to uphold the ALJ's determinations if they were supported by substantial evidence, and (2) the ALJ's determinations were so supported.

Nevada statute provides that a "court shall not substitute its judgment for that of the agency as to the weight of evidence on a question of fact." The court may, however, set aside the agency's decision if it is based on an error of law or is "clearly erroneous in view of the reliable, probative and substantial evidence on the whole record."[24]

Moreover, Nevada statute directs that when an ALJ's decision is appealed to the State Tax Commission, that body must comply with the same standard of review just quoted.[25] Thus, the *Masco* court held: "if the ALJ's findings were supported by substantial evidence, the Tax Commission was prohibited from substituting its own judgment for that of the ALJ."[26]

Although Nevada's review scheme is not the norm in its totality, it is the norm in its use of the substantial evidence test. This is the most widely used standard in formal adjudications at both the state and federal levels.[27]

Substantial evidence is "that which a reasonable mind would accept as adequate to support a conclusion. [It] consists of more than a scintilla of evidence, but less than a preponderance of the evidence."[28] The substantial evidence determination is made based on the whole record, considering both the aspects of the record that support the agency's decision and the aspects that are contrary to it.[29]

Central to the *Masco* dispute was notation on the Root-generated invoices of the line-item "sales tax." The auditor and the commission saw that as proof that Masco was acting as a retail seller. In contrast, Masco argued that the line-item resulted from Root's computer-generated accounting oversight. At the ALJ hearing, Masco presented oral and documentary evidence in support of its explanation. The ALJ made detailed findings in Masco's favor. Yet the commission failed to address those detailed findings and the evidence on which they were based.[30]

The Nevada Supreme Court found that Masco's documentary and oral evidence easily constituted substantial evidence. The commission therefore failed to accord proper deference to the ALJ's decision.[31]

The *Masco* result might have been reached even in a jurisdiction in which deference is owed to the agency, not its ALJs. Even in those jurisdictions, the agency's decision will be reversed if not supported by substantial evidence. The ALJ's view gains weight because the ALJ "sees the witness and hears them testify, while the [agency] and the reviewing court look only at cold records."[32] The MSAPA accordingly provides that the agency head reviewing an ALJ's order "shall consider the presiding officer's opportunity to observe the witnesses and to determine the credibility of witnesses."[33]

Even when the agency reverses its ALJ's decision, that decision remains part of the record and is part of the substantial evidence evaluation.[34] Thus, an agency's "supporting evidence, in cases where it rejects the examiner's findings, must be stronger than would be required in cases where the findings are accepted."[35]

Equitable Tolling Issue

I examined the doctrine of equitable tolling in an earlier installment of this column.[36] *Masco* usefully illustrates the doctrine in action.

In general, "equitable tolling is judge-made doctrine which operates independently of the literal

[22]"On appeal from or review of the initial decision, the agency has all the powers which it would have in making the initial decision." 5 U.S.C. section 557(b).

[23]Flanagan I, *supra* note 14, at 1359; *see also* Rossi, *supra* note 14, at 55-64.

[24]Nev. Rev. Stat. 233B.135(3).

[25]Nev. Rev. Stat. 360.390(2).

[26]265 P.3d at 670.

[27]*See, e.g.,* 5 U.S.C. section 706(2)(E); MSAPA section 508(a)(3)(D).

[28]*Great Lakes Sales, Inc. v. State Tax Comm'n,* 486 N.W.2d 367, 372 (Mich. App. 1992); *see also NLRB v. Columbian Enameling & Stamping Co.*, 306 U.S. 292, 300 (1939); *Consolidated Edison Co. v. NLRB,* 305 U.S. 197, 229 (1938).

[29]*See, e.g., Universal Camera Corp. v. NLRB*, 340 U.S. 474, 488-489 (1951); *West Ottawa Ed. Ass'n v. West Ottawa Pub. Schools Bd. of Ed.*, 126 Mich. App. 306, 313 (1983).

[30]265 P.3d at 670.

[31]*Id.* at 670-671.

[32]*NLRB v. Walton Mfg. Co.*, 369 U.S. 404, 408 (1962). Although that is the conventional wisdom of American courts, it is subject to debate. *See, e.g.,* Max Minzer, "Detecting Lies Using Demeanor, Bias and Context," 29 *Cardozo L. Rev.* 2557 (2008) (noting that "the consensus in the legal and social science literature is almost the opposite" but challenging that consensus).

[33]MSAPA sections 414(e) and 415(b).

[34]*Universal Camera, supra* note 29, 340 U.S. at 493.

[35]Steve R. Johnson, "Equitable Tolling in State and Local Tax Cases," *State Tax Notes*, June 15, 2009, p. 917, *Doc 2009-12539*, or *2009 STT 113-2*.

[36]*Lantzy v. Centex Homes*, 73 P.3d 517, 523 (Cal. 2003) (internal punctuation omitted).

wording of the [statute] to suspend or extend a statute of limitations as necessary to ensure fundamental practicality and fairness. It applies in carefully considered situations to prevent the unjust technical forfeiture of causes of action where the [opposing party] would suffer no prejudice."[37]

Courts apply equitable tolling narrowly. The Nevada courts have developed a nonexclusive list of factors to guide application of the doctrine. They include:

> the diligence of the claimant; the claimant's knowledge of the relevant facts; the claimant's reliance on authoritative statements by the administrative agency that misled the claimant about the nature of the claimant's rights; any deception or false assurances on the part of the [agency] against which the claim is made; the prejudice to the [agency] that would actually result from delay during the time that the limitations period is tolled; and any other equitable considerations in the appropriate case.[38]

The Nevada Supreme Court found the following factors persuasive in *Masco*. First:

> Masco told the Tax Department's auditor that it was requesting a refund, stated its basis for the refund, and the auditor communicated this stance in writing to his supervisors at the Tax Department. Thus, the only shortcoming in Masco's refund request was its failure to send the Tax Department its own letter to the same effect.[39]

Second, the department was not prejudiced by allowing Masco's refund claim to be considered. It "was fully apprised of Masco's basis for its refund request from the inception of the audit, and because it has already denied the request, we assume that it has already fully investigated the matter."[40]

Third, regarding equity, the court acknowledged that Masco is a large company with the wherewithal to investigate whether a formalized refund request was needed. That fact was overborne, however, by the following considerations:

> (1) the original auditor's assurances "effectively lulled Masco into a false sense of security";
>
> (2) Masco diligently attempted to contact someone within the department and the failure to renew the waiver "was solely the result of the Tax Department's failure to return Masco's phone calls and its own disorganization"; and
>
> (3) the department "actively participated in and contributed to Masco's delay in filing its formal refund claim."

Conclusion

Masco is an instructive case, and it should prove useful to taxpayers in many jurisdictions. First, in states that use ALJs as part of the tax controversy resolution process, *Masco's* treatment of "to whom is deference due?" should be relevant. Although the statutory standard of review may differ, the underlying premise that the ALJ's view matters significantly should be transportable. Second, equitable tolling is recognized in most jurisdictions. *Masco's* careful weighing of factors reminds us that although equitable tolling is not granted lightly, it is a viable option on proper facts. ☆

Interpretation Matters is a column by Steve R. Johnson, University Professor of Law at the Florida State University College of Law. He can be contacted at sjohnson@law.fsu.edu.

[37] *Copeland v. Desert Inn Hotel*, 673 P.2d 490, 492 (Nev. 1983); *see also Seino v. Employers Ins. Co. of Nevada*, 111 P.3d 1107, 1112 (Nev. 2005).

[38] 265 P.3d at 671-672.

[39] *Id.* at 672.

[40] *Id.*