

American Bar Association  
The Supreme Court's Federal Tax Jurisprudence

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### Ch. I. Tax Principles Addressed and the Interpretive Context

#### \*1 I.A. Tax Application Principles Addressed

The following subchapters summarize the principles of application of the federal tax laws that later chapters will expound.

##### I.A.1. *Evolution of the Application of the Federal Tax Laws*

The methods of applying the United States tax laws have evolved since the early days of customs duties and stamp taxes, through the early income tax period, to today. But the stages of evolution are mostly overlooked, resulting in continuing references to outmoded authorities and incomplete understanding of others.

Most disputes about the application of the federal tax laws involve relatively straightforward uncertainties about facts and the meaning of tax statutes, which are recognized and treated as issues of fact and law. But a substantial number of tax disputes are analyzed on bases other than standard law and fact finding. These cases generally start with what can best be called a feeling on the part of the Service, then urged on a court, that the taxpayer's claimed tax benefit just cannot be so. That feeling, administratively well intentioned though it may be, has spawned a large body of unorganized, episodic applications of the tax laws that defies structure. This body of law encourages the view that tax is special, that the courts discern some grand truths that underlie, but are not written in, the tax laws, and that there is a third legal process \*2 to be applied to tax, apart from standard fact and law finding. This book is based on the premise that tax law is not special, [FN2] that there are no such grand truths, nor is there a third process.

Instead, in the early days of taxation by statute in England and America there existed the common law and the effort of the judges to accommodate the new statutes to the common law. Initially in this effort the common law was exalted and statutes were strictly interpreted, except when they were intended to remedy the shortcomings of the common law (called remedial statutes); penal statutes also were strictly construed. Tax statutes were hard to pigeonhole, but because they clearly were not remedial of the common law and frequently were enforced by the criminal law, they tended to fall in the penal category and to be strictly construed against the government.

By the time of the enactment of the 1913 income tax, the tendency to view statutes generally in terms of their relation to the common law had waned and faith in the legislatures increased. The courts began to view themselves in partnership with legislators, and tried to carry out the purposes of Congress in their rulings. Thus, the paradigm of taxation shifted from being viewed as a penal law to being like a remedial law, but with a peculiar twist: the person in need of the remedy was the government. This shift appears most prominently in the opinions

of the New Deal Supreme Court to 1960 (the beginning of the Warren Court).

Particularly in the New Deal period, in tax cases the federal courts applied methods of fact finding that had developed in the courts of equity: for example a core principle of equity jurisprudence is that substance should control over form in order that right should be done. Initially the Supreme Court applied such approaches in favor of taxpayers, but the New Deal Supreme Court applied them more in favor of the government. In addition federal courts began to construe tax statutes as they would a remedial statute like the usury statutes, to achieve the intent or purposes of Congress. For example, the Supreme Court construed several statutorily unstated requirements into the definition of a corporate reorganization, thus further limiting taxpayers' ability to literally apply the statute to obtain gain nonrecognition.

Although it was frequently stated that there should be a balanced approach to interpretation of taxing statutes, during the New Deal period the federal courts made two defining and interrelated pro-government choices in interpreting the revenue statutes: (1) they came to define income very broadly; and (2) they generally applied a rule of construction that deductions and allowances should be strictly interpreted. These two presumptions or canons do or can constitute a heavy thumb on the scales of the tax law in favor of the government as the person needing the remedy, wholly apart from equitable fact finding in favor of the government.

\*3 However, no one seems to have observed, understood or explained these shifts in tax application toward favoring the government in the New Deal period. Grasping for an explanation of the new status quo, the lower federal courts developed tax specific explanations for their pro-government tendencies in fact finding and legal construction. They strove mightily to drain every ounce of support from a handful of Supreme Court opinions--*Gregory, Smith, Knetsch, Frank Lyon*--which frequently do not provide that support and are better explained in more traditional terms of legal construction and fact finding.

Initially the Board of Tax Appeals took a relatively literal view of the tax statutes, which academics now would call "textualist." However, over time the Board (and later the Tax Court) shifted to a "purposive" approach that both gave relatively more weight to Congress' presumed purpose, but also gave relatively less weight to the transaction's form. The likely explanation is that the Tax Court came more and more to view itself as the steward of the tax laws, and its members felt the need to protect that law. The appellate courts picked up their cues from the Tax Court (as well as from a series of well-regarded tax opinions by Second Circuit Judge Learned Hand), and in concert they created several tax specific doctrines, sometimes justified with miscitations of Supreme Court decisions mostly from the 1930's and 1940's. The flowering of these doctrines in the lower courts mostly occurred after 1960 (and accelerated in the 1980's) when the courts otherwise generally were trending away from the purposive approach to statutory interpretation back toward a sort of second generation textualism.

As a result of these shifts lower federal courts commonly commence their analyses of tax disputes by stating baldly several doctrines: that in the tax law substance rather than form always determines the result (which rightly understood is no more than an assertion of common law fact finding), a bona fide business purpose is always a prerequisite for respecting a transaction for tax purposes (which is a lower court extension of a more restricted legal interpretation in *Gregory v. Helvering*), and the economic substance of a transaction will always be discerned and will control the tax result despite the intervention of entities, or contracts, or other legal rights (which is either another way to assert common law fact finding, or is a positive rule of law when it appears as part of the economic substance doctrine). The availability of such doctrines obscures the fact that courts are frequently applying equitable fact finding tools and standard construction of ambiguous statutes sections based on

the purposes of Congress.

The better way, indeed the more lawyerly way, may be to codify these doctrines, if they are to be the law. [FN3] But in addition we need to understand (1) the true origins and meaning of these doctrines and the more fundamental legal methods from which they derive, (2) that tax law is not special, and (3) \*4 that courts have known for centuries how to determine that an ass bearing the label “horse” is still an ass.

#### I.A.2. *Fact Finding, Statutory Interpretation, and the Supreme Court*

This book focuses on the two core processes of the law--statutory interpretation and construction and fact finding--as they have been applied by the Supreme Court of the United States in federal tax cases. The book employs these two categories not only as an organization tool, but also because the relatively simple step of recognizing which process is being applied can go far in clarifying what a court has done. Many denigrate the fact and law distinction, particularly in the tax area; whatever limitations it may have for purposes of appellate review, it well serves the purposes identified here. [FN4] A secondary focus of this book is on certain judge made doctrines (“tax specific doctrines”) sometimes thought generally to govern the interpretation and application of the Internal Revenue Code (herein “the Code”). [FN5] This book will show that the tax jurisprudence of the Supreme Court does not embody the doctrines. [FN6]

Although the words “interpretation” and “construction” now appear to be used interchangeably, [FN7] they are epistemologically different and maintaining the distinction is useful. [FN8] Interpretation discerns meaning from the words of the statute, possibly as influenced by a variety of extrinsic sources; construction fills a gap and sometimes reads the statute contrary to its words, and is similarly influenced. Thus these two processes match up with two of the problem areas this book addresses: ambiguous sections of the Code and unambiguous sections that produce benefits for taxpayers that the Service finds unintended.

Statutory interpretation and construction may be either liberal or purposive or intentionalist, or it may be strict and literal and textualist. The choice between these two poles frequently is treated as the choice answered by the tax specific doctrines, but it is not. [FN9] Although the doctrines may depend somewhat on purposive statutory interpretation, more generally they set up a false choice between a blinkered view of facts and an integrated view, sometimes invoking the “step transaction doctrine” or “substance over form doctrine” or \*5 “economic substance doctrine.” There is no such choice: the law has always known how to find facts, despite fraud and lesser methods of obscuring facts. When law and fact finding processes are disentangled, many cases based on the doctrines can be seen as law cases or fact cases or as otherwise reflecting standard legal processes, not necessarily peculiar to the tax laws and not dependent on a judge made positive rule of law.

The judge made doctrines referred to above try to substitute for normal purposive interpretation of statutes and for doing the hard work of finding facts using common law and equity tools. This book makes, and will support, the following points.

- *Tax specific doctrines*: The lower federal courts, the Service and most taxpayer representatives have come to believe that the Service can deny a tax benefit to a taxpayer if (a) the substance of the transaction does not comport with its form, or (b) the transaction does not have economic substance, or (c) the transaction has no business purpose (generally some variation of the *economic substance doctrine*). [FN10]
- *Lack of balance*: The doctrines do not reflect a general application of purposive interpretation to the Code because they operate in only one direction: they deny benefits that the courts presume Congress did not intend, while not extending benefits that the Congress presumably did intend.

- *Partially debunking the doctrines:* In fact the most authoritative sources of federal tax law, Congress, the Supreme Court, [FN11] and Treasury regulations, have not adopted generally applicable positive rules of Code application, although the Supreme Court has adopted methods of fact finding in cluster areas; but see Ch. V.F. on codification of the economic substance doctrine.

- *Lack of synthesis of principles of application of the income tax:* The doctrines have arisen without those three sources of authority principally because of the over abundance of case law that has been poorly synthesized, and because inherent features of a progressive income tax tend to promote the development of anti-taxpayer doctrines, of which these are the handiest.

- *Proper synthesis:* Despite debates over textualism versus purposivism, the two courts most relevant to the application of the tax laws, the Tax Court and the Supreme Court, tend (1) to interpret the Code to carry out the purposes of Congress, (2) to do so more readily in favor of the government,\*6 and (3) to use equitable fact finding methods that have been given tax-specific names (economic substance doctrine, etc.) but have deep historic roots in common law and equity.

- *Building a synthesis out of Supreme Court tax opinions:* In lieu of doctrines, Code users can observe as more authoritative the methods used by the Supreme Court in applying the Code, on which this book focuses.

- *Cluster rules:* In place of generally applicable positive rules like the economic substance doctrine (ESD), the study of the Supreme Court's methods suggests a more modest set of truly tax specific doctrines that this book calls cluster rules; they can form a more orderly template for Code application that will be readily accessible to users and can avoid misapplication of authorities; specifically, the economic substance doctrine properly is a cluster rule that originated to assist fact finding in the area of leveraged leases, and has metastasized into a general purpose rule of positive law.

- *Agency and equity:* Principles of agency and equity (and step transaction concepts) are the fundamental tools that the law normally uses to cause substance to override form; the tax law has woefully disregarded these tools.

- *Alternatives for law reform:* Despite the vast store of Supreme Court tax guidance, the Court's waning ability to provide, or show any interest in providing, ongoing oversight in the federal tax area may lead to a need for systemic changes of which the codification of the economic substance doctrine may unfortunately be an example.

The rise of the judge made doctrines roughly coincides with the rise of the tax shelters of the 1970's and later, and the absence of an authorized pro-taxpayer or pro-government tilt in the interpretation of the tax laws (aside from the broad definition of income and the strict construction of deductions and allowances). Others have addressed many of these subjects, but usually with one or more of three major limitations: (1) failure to question the historical roots of various doctrines; [FN12] (2) more concern with relating the subject to some one rule, [FN13] or one case, [FN14] instead of the broader problem of Code application; and (3) a bias against tax avoidance. [FN15] Also, at least one major empirical study of the Supreme Court's tax jurisprudence exists, which provides invaluable evidence on which this book relies, but does not relate the Court's approaches to the doctrines or attempt to synthesize a method of \*7 Code application. [FN16]

The only tax law that is of parallel legitimacy to the Code is the tax law made by the Supreme Court. This book chooses to rely solely on the Supreme Court's tax jurisprudence for several reasons in addition to its primacy: (1) the body of its tax decisions is sufficiently large (over 900) to form a useful body of law; (2) the welter of lower court decisions was not cohesive 60 years ago when Randolph Paul tried to encapsulate it, [FN17] and is less so now (except to the extent the economic substance doctrine has coalesced as a positive rule of law in the lower courts); (3) the passage of time and the gradual diminution of the Court's involvement in tax

issues has dimmed knowledge of its earlier rulings; and (4) founding an interpretive approach on the Supreme Court's tax jurisprudence is an attainable middle ground between purely theoretical approaches to statutes, and purely empirical studies, which are not abundant in the tax law. [FN18] The excellent empirical studies of Supreme Court tax cases by Professor Staudt, *et al*, that have been done largely are consistent with the approaches discussed herein, as discussed in Ch. III.C.2 below. [FN19] The only group of Supreme Court tax opinions that is intentionally not examined in this book is the constitutional cases.

### I.A.3. *The Problem of Code Application*

The need for clear understanding of the federal tax law is great because the impact of the Code on all persons is tremendous: virtually everyone pays or is subject to paying federal taxes, and the government relies on taxes for its life blood. But rules and methods for Code application are in disarray because:

- statutory and administrative tax law tends to be made, or at least influenced, by tax experts, who too frequently are not in close contact with other branches of the law, and thus tend to view tax law as isolated, self sufficient, and not in need of fertilization by general legal learning; [FN20]
- the voluminous controlling interpretations of the law makes synthesis difficult;
- interpretation of the Code is not a common subject of study; [FN21]
- the tax law is notoriously complex;
- the tax law has not adequately worked out the relationship between application\*8 of general law principles to tax issues and tax-specific rules; [FN22] and
- these factors tend to impel the Service, and then the lower courts, to default to broadly applicable tax-specific doctrines (such as the economic substance doctrine) that do not require full understanding and application of the nuances of the sections at issue.

Put another way, the Code suffers from its own “popularity”: it is a means to widely differing ends for its users, which is all of us, and its use cannot be avoided. It is a means to tax reduction in a multitude of ways for taxpayers, and a means to indispensable revenue raising for the government; in addition it has become a means to implement a variety of social programs. Its unavoidable ubiquity and built in conflicts distinguishes the Code from other bodies of statutory law, such as the criminal law or the federal bankruptcy Code, which come into play only episodically, and which most can avoid. Therefore, application of the Code is a subject of the highest economic and social importance.

The Code's popularity has resulted in a huge volume of disputes between government and taxpayers producing a similarly huge volume of precedents. Many interpretational disputes result from (1) the absence of authoritative policies on Code interpretation and application, (2) the hodge podge of judge made policies on Code application that go in and out of favor, and (3) the withering of more traditional processes in favor of certain judge made doctrines. The lower federal courts, urged on by a vitally interested partisan, the Service, have attempted to supply such authoritative interpretive policies by creating particularly the ESD. The meaning and scope of the ESD and the doctrines generally have been uncertain, except in one sense: they always favor the government. They function as a sort of general anti-abuse rule (GAAR). [FN23]

The government seems to find the resulting *in terrorem* effect more beneficial to the fisc than clearer rules around which taxpayers might maneuver. [FN24] Taxpayers generally have deplored the uncertainty of the doctrines, but embrace some of the other judge made policies and have opposed the codification of broad anti-abuse rules. [FN25] In encouraging the lower courts to create particularly the ESD the Service has violated its own policies: “The \*9 proper method for conveying the positions of the Office and the policies of the Service is

through published guidance. In contrast, litigation should be used as an enforcement tool to advance and defend established positions, not as a vehicle for making policy.” [FN26]

Examples of the Code's interpretive uncertainties that result from the judge made doctrines and from failing to apply more standard legal methods include:

- retention of outmoded policies: a hotly contested 2007 D. C. Circuit Court of Appeals opinion [FN27] cites a 1917 Supreme Court opinion [FN28] for the policy that ambiguous revenue raising sections should be construed in favor of the taxpayer, despite the fact that the Supreme Court long ago abandoned that authority; [FN29]
- statement of Supreme Court “rules” that do not exist: a Tax Court judge in a frequently cited “tax shelter” opinion [FN30] relied upon *Gregory* [FN31] as creating
- a “business purpose” requirement for apparently all tax-favorable transactions, [FN32] even though *Gregory* did no more than interpret the words “pursuant to a plan of reorganization”; [FN33]
- a section that the Congress intended and the Treasury embraced as an actual but limited anti-abuse rule, section 269, which has been gutted by the courts and ignored by the Service and Treasury; [FN34] and the repeated statement that “. . . the doctrine of ‘substance over form’ recognizes that the substance of a transaction, rather than its form, governs for tax purposes,” [FN35] when, in fact, sometimes it does and sometimes it doesn't. [FN36]

As a result of these and many, many, more legal cross currents, proposals were made between 1999 and 2010 to codify the economic substance doctrine. See Ch. V.F. for discussion of codification. The question of the authority of the ESD has become more prominent since about 1980 when the Service \*10 began to assert doctrines generally and the ESD in particular in virtually all cases it considered to be tax shelters, and thereafter when the lower federal courts began to agree and to treat the doctrines as transitioning from fact finding methods in cluster areas to ever more rigid, but no less uncertain, rules of positive law. [FN37]

The most fundamental of the causes of the problems of Code application seems to derive from the failure to adequately work out the relationship between the general law rules application to tax issues and the special tax rules. The general law rules mostly derive from the laws of 50 states. This causes an inherent potential lack of uniformity in the federal tax law. In addition, there are express or implied statutory meanings in the Code that find no analogs or even sound guides in state law characterizations (income being the chief one). Therefore the creation of tax specific rules has been inevitable, but chaotic. [FN38] At one end of the spectrum is the development by the Supreme Court of a genuine general principle of Code application, the assignment of income doctrine, as well as other cluster rules discussed in Ch. VI.F; at the other end is the application by the lower federal courts of the ESD, which they use to override a wide variety of forms chosen by taxpayers.

Finally, Justice Robert H. Jackson pointed out a special cause of the peculiar British-American difficulty with tax administration. He explained that continental legal systems had worked out a way to treat administrative law as different from private disputes. In contrast, the only way a taxpayer could initially contest a federal tax was to sue the tax collector for acting outside the law. Though this method was changed, “the earlier method of thinking has colored our whole development of administrative law.” [FN39]

#### I.A.4. *Imbalance: The Service Versus The Taxpayer*

The federal tax laws have enjoyed a century long movement, unevenly but inexorably, against the taxpayer and in favor of the government. The judge made doctrines discussed in this book arose to combat “tax shelters”

and provide flexibility in the tax law in only one direction: against taxpayers. Important aspects of the trend include the following:

- Taxpayers have lost the 19<sup>th</sup> century presumption that taxes are to be strictly construed against the government, which has been replaced by a broad definition of income and pro-government presumptions as to deductions, nonrecognition, and allowances. [FN40]
- \*11 • The principles of equity are not employed in favor of taxpayers; indeed no actor in the system is authorized to do equity for taxpayers. [FN41]
- Although taxpayers beat back the *Dobson* rule [FN42] so that the Tax Court does not have near total control over fact finding in its cases, that taxpayer victory has been mostly neutralized by the tax specific doctrines, which sometimes operate like factual presumptions for the government.
- Taxpayers are subject to the presumption of correctness of the Commissioner's determination and the burden of proof is on the taxpayer to prove its case. [FN43]
- The courts show substantial deference to federal agency regulations in general and Treasury regulations in particular. [FN44]
- Taxpayers must clearly prove any waiver of procedural requirements by the Service. [FN45]
- Penalties have become progressively heavier, and are now aimed also at tax advisors. [FN46]
- Congress has created and increased requirements that taxpayers notify the Service of questionable positions. [FN47]
- The Service will not rule on a transaction lacking a bona fide business purpose or having a principal purpose of tax reduction. [FN48]
- Financial accounting standards have come to impose almost as much constraint on tax reduction activity by reporting companies as the tax laws themselves. [FN49]
- Many statutory changes have effected broad scale as well as targeted tax benefit disallowance rules, such as the repeal of the *General Utilities* Doctrine in 1986, [FN50] enactment of the passive loss rules of section 465, and the 2004 enactment of section 409A curtailing flexibility in deferred compensation.
- However, in the area of forum selection, taxpayers have suffered the least erosion of their rights, enjoying maximum flexibility in the choice of three trial court venues, with their varying routes of appeal; [FN51] but taxpayers\*12 have never had a constitutional right to a prepayment remedy; [FN52] and all courts seem to be tending to rule against “tax shelters.”

These changes and rules weigh heavily against taxpayers, leaving to the taxpayer the principal advantages of choice of form, choice of forum, and self reporting (and minimal audit coverage, subject to self-identification of questionable positions).

#### I.A.5. *Methodology and a Caution*

This book mostly ignores lower court opinions (except for their creation of the economic substance doctrine), and cites most of the Supreme Court tax decisions since 1913, the bulk of which date from the first half of the 20<sup>th</sup> Century. The choice of Supreme Court over lower court decisions is motivated both by supremacy and triage: focus on the Court's authoritativeness trumps a futile attempt at completeness that will yield incoherence. It turns out that the Supreme Court's tax opinions do support a coherence that can inform the broader case law. However, this book mostly ignores Supreme Court decisions on constitutionality of federal taxes, except for the unavoidable *Eisner v. Macomber*, because of their peculiar and limited impact on broader matters of Code interpretation.

Admittedly the interpretational styles of the Court have changed over its history, beginning with a creative or

“grand” style employed by Chief Justice Marshall, moving to a more formal precedential style by the end of the 19<sup>th</sup> century, and moving back toward creativity in the first part of the 20<sup>th</sup> century, [FN53] with more current emphasis on formality and text. Since style per se is not a ground for distinguishing an opinion, emphasis on all of the Supreme Court precedent under the tax laws is justifiable on several grounds:

- The Court is proud of its own decisions, and will follow them to a near fault. [FN54]
- Absent a fairly clear reversal, “old” Supreme Court decisions remain good law, despite frequently being ignored or just forgotten.
- Very few of the current problems of tax law application are of a new variety.

\*13 This book also cites many “old” articles and tax books, generally for the purpose of gaining contemporaneous understanding of past tax events. Many brilliant students of the tax law, including Randolph Paul, Louis Eisenstein, Erwin Griswold, Boris Bittker, Stanley Surrey, William Plumb (holding the list to the deceased), have studied the matters discussed here, and made recommendations, or at least recorded ideas, that are useful today, but also tend to be ignored or forgotten. Tax folk seem to like to reinvent wheels and ignore what went before.

Because this is also a reference book, it assumes that the law, and how it is employed, actually matter in deciding legal cases and in applying the tax law apart from litigation. There are many contrary or contrasting academic viewpoints, summarized in Ch. I.B.1. below, which espouse theoretical approaches to the tax law that this book eschews. Like Randolph Paul's works, [FN55] this book attempts to address what the law is. Even “critical legal studies” proponents agree that law places some constraints on judges. [FN56] Moreover, close observers will agree that within the government there is widespread and honest fealty to the law and congressional purpose, and that responsible tax advisors do attempt to know the law. Therefore, trying to discern what the tax law is must be important.

Finally, this book relies on close attention to what courts, and specifically the Supreme Court, say and do in their written opinions, with emphasis on their holdings as contrasted with their dictum. Many of the key points of this book are based on accurate readings of Supreme Court precedents, which are frequently at odds with the gloss created by hindsight.

[FN2]. Cf. Livingston, *Practical Reason, Purposivism and the Interpretation of Tax Statutes*, 51 *Tax L. Rev.* 677, 679 (1996) (agreeing that tax is not unique in the law as to statutory interpretation, though it is on one end of a spectrum of general to specific statutes).

[FN3]. See *infra* Ch. V.F. (on codification of the economic substance doctrine).

[FN4]. See Pietruszkiewicz, *Economic Substance and the Standard of Review*, 60 *Ala. L. Rev.* 339, 359 (2009).

[FN5]. Title 26 of the United States Code.

[FN6]. The idea for this book's focus on the Supreme Court's tax opinions took form in Cummings, *Statutory Interpretation and Albertson's*, 66 *Tax Notes (TA)* 559 (Jan. 23, 1995).

[FN7]. For three Tax Court opinions using the terms interchangeably, see *Liddle v. Commissioner*, 103 *T.C.* 285

(1994); *Hesselink v. Commissioner*, 97 T.C. 94 (1991); *Estate of Keller v. Commissioner*, 39 B.T.A. 1047 (1939).

[FN8]. See Pierce, *Administrative Law Treatise* § 3.3 (2000). The distinction has been traced to Lieber, *Legal and Political Hermeneutics* 23 (Boston, Little Brown 1837). See Popkin, *Statutes in Court* 68 (Duke 1999).

[FN9]. See, e.g., McLeod, *Collecting Taxes*, 33 Victoria Univ. Wellington L. Rev. 371, 379 (2002) (discussing the British tax law's evolution after the Duke of Westminster case and reciting British judge's views on the twin aspects of tax law process).

[FN10]. One summary statement of the judicial doctrines says “[T]ransactions are to be taken at face value for tax purposes only if they are imbued with a ‘business purpose or reflect economic reality’ . . .” Bittker & Lokken, *supra* note 1, at ¶ 4.3.1. These are rules that dictate how other rules should be applied, interpreted, and construed. The Treasury has almost described them as such, stating that they “overlay the rules [referring to the Code, regulations and other administrative pronouncements].” *Treasury White Paper on Corporate Tax Shelters IV*, 1999 Tax Notes Today 127-12 (July 1, 1999) (also referring to the doctrines as “standards”).

[FN11]. See Madison, *The Tension Between Textualism v. Substance Over Form*, 43 Santa Clara L. Rev. 699, 749 (2003) (agreeing that the Supreme Court is likely to reject one or more of the doctrines if asked).

[FN12]. See, e.g., Bankman, *The Economic Substance Doctrine*, 74 S. Cal. L. Rev. 5 (2000) (starting with the existence of the doctrine as a given).

[FN13]. See, e.g., Cunningham and Repetti, *Textualism and Tax Shelters*, 24 Va. Tax Rev. 1 (2004) (focusing on the partnership anti-abuse rule).

[FN14]. See, e.g., Donahue, *The Rule of Sheldon v. Commissioner: Is it an Economically Efficient Evolution of the Sham Transaction Doctrine?*, 13 Va. Tax Rev. 165 (1992).

[FN15]. See, e.g., McMahon, *Beyond a GAAR: Retrofitting the Code to Rein in 21<sup>st</sup> Century Tax Shelters*, 98 Tax Notes (TA) 1721 (Mar. 23, 2003) (arguing not only that there is no right to tax planning but it is not a societal value).

[FN16]. Staudt *et al.*, *Judging Statutes: Interpretive Regimes*, 38 Loy. L.A. L. Rev. 1909 (2005).

[FN17]. Paul, *Studies in Federal Taxation* (Callaghan 1937) (hereinafter Paul, *Studies in Federal Taxation I*).

[FN18]. See Staudt, *Empirical Taxation*, 13 Wash. U. J.L. & Pol'y 1 (2003). Another example of a useful empirical study is Shores, *Textualism and Intentionalism in Tax Litigation*, 61 Tax Law. 53 (2007) (finding that the

Tax Court is more likely to ignore the words of the Code to reach the “correct” result than are courts of appeal).

[FN19]. Staudt *et al.*, *Judging Statutes*, *supra* note 16, at 1909.

[FN20]. Paul, *supra* note 17, at 66.

[FN21]. Barker, *Statutory Interpretation, Comparative Law, and Economic Theory: Discovering the Grond of Income Taxation*, 40 *San Diego L. Rev.* 821, 825 (2003).

[FN22]. See Reiling, *Developing a Law of Income Taxation*, 32 *Taxes (CCH)* 546 (1954) (author was Assistant Chief Counsel of the Service; he observed that at least as of 1954 the tax law had not been logically organized in terms of those two types of rules).

[FN23]. For discussion of GAAR, generally, see West, *Antiabuse Rules and Policy: Coherence or Tower of Babel?*, 118 *Tax Notes (TA)* 513 (Jan. 28, 2008).

[FN24]. See Office of Mgmt. & Budget, Executive Office of the President, Statement of Administration Policy, Food and Energy Security Act of 2007, H.R. 2419, *available at* 2007 *Tax Notes Today* 216-41 (Nov. 6, 2007).

[FN25]. See, e.g., N. Y. State Bar Ass'n Section of Taxation, *Comments on the Administration's Corporate Tax Shelter Proposals*, 83 *Tax Notes (TA)* 879 (May 10, 1999) (rejecting nonspecific anti-abuse statute “super 269”); *infra* Ch. V.F (codification of the economic substance doctrine).

[FN26]. I.R.M. 31.1.1.1.3(1); cf. Sheppard, *Government Officials Discuss Partnership, Shelter Issues*, 2007 *Tax Notes Today* 107-1 (June 4, 2007) (statements of former Chief Counsel Korb explaining use of litigation to flesh out meaning of statute).

[FN27]. *Murphy v. Internal Revenue Service*, 493 F.3d 170 (D.C. Cir. 2007), *reh. denied*, 100 A.F.T.R. 2d 6049, *cert. denied*, 128 S. Ct. 2050 (2008).

[FN28]. *Gould v. Gould*, 245 U.S. 151 (1917).

[FN29]. See *infra* Ch. II.B.2(c)(4).

[FN30]. *ACM P'ship v. Commissioner*, 1997 T.C.M. (RIA) ¶ 97,115, *aff'd*, 157 F.3d 231 (3d Cir. 1998).

[FN31]. *Gregory v. Helvering*, 293 U.S. 465 (1935).

[FN32]. See Cavanaugh, *Order in Multiplicity: Aristotle on Text, Context and the Rule of Law*, 79 N.C. L. Rev. 577, 602 n. 77 (2000) (which attributes such a general doctrine to *Gregory* without citation or a second thought).

[FN33]. See *infra* Ch. V.F.2 (roots of economic substance doctrine); *infra* Ch III.C.3.a(1) (*Gregory*).

[FN34]. See *infra* Ch. IV.A.

[FN35]. See, e.g., *BB&T Corp. v. United States*, 523 F.3d 461 (4th Cir. 2008).

[FN36]. See *infra* Ch. VI.E.1.

[FN37]. See Gideon, *Mrs. Gregory's Grandchildren: Judicial Restrictions of Tax Shelters*, 5 Va. Tax Rev. 825-26 (1986) (decrying the uncertainty of the judicial doctrines and stating that the uncertainty might have been tolerable earlier, but not now that they had become so widespread).

[FN38]. See generally Reiling, *supra* note 22, at 546-58 (July 1954).

[FN39]. Jackson, *The Supreme Court in the American System of Government* 47 (Harper 1963) (1955).

[FN40]. See *infra* Ch. II.B.2(c)(4).

[FN41]. See *infra* Ch. V.E.1.f.

[FN42]. The *Dobson* case applied a fairly clear statute to remove factual findings made by the Board of Tax Appeals from appellate review. See *infra* Ch.VI.E.3.a.

[FN43]. See *infra* Ch. VI.E.4.

[FN44]. See *infra* Ch. VI.D.

[FN45]. *Angelus Milling Co. v. Commissioner*, 325 U.S. 293 (1945).

[FN46]. Bittker & Lokken, *supra* note 1, at ¶ 114.2.

[FN47]. Bittker & Lokken, *supra* note 1, at ¶ 111.1A.

[FN48]. Rev. Proc. 2009-3, 2009-1 I.R.B. 107, § 3.02(1).

[FN49]. See, e.g., Gamino, *The (New) Other Side of the Planning Coin: Identification and Disclosure of Tax "Uncertainty,"* 105 J. Tax 227 (2006).

[FN50]. Bittker & Eustice, *Federal Income Taxation of Corporations and Shareholders* ¶ 8.20 (7th ed. 2000).

[FN51]. The United States Tax Court, United States District Courts, and The United States Claims Court, appealable variously to the Circuit Courts of Appeal and the Court of Appeals for the Federal Circuit.

[FN52]. *Phillips v. Commissioner*, 283 U.S. 589 (1931) (shareholders of liquidated corporation can be subject to summary collection procedures).

[FN53]. See Llewellyn, *Remarks on the Theory of Appellate Decisions*, 3 Vand. L. Rev. 395, 396 (1950) (tracing how Marshall relied on principle over precedent, referred to as the Grand Style; then in the period of 1880-1910 the Formal Style depended more on precedent; thereafter the Grand Style began to creep back in).

[FN54]. See Brudney and Ditslear, *The Warp and Woof of Statutory Interpretation: Comparing Supreme Court Approaches in Tax Law and Workplace Law*, 58 Duke L.J. 1231, 1253 (2009) (survey showing 81.6% reliance on Supreme Court precedent in tax cases, substantially greater than any other measured ground, including text); see also, *United States v. Hatter*, 532 U.S. 557, 567 (2001) (only the Supreme Court can overrule its own prior decisions).

[FN55]. Paul, *Studies in Federal Taxation I*, *supra* note 17; Paul, *Studies in Federal Taxation* (2d ed. 1938) (hereinafter Paul, *Studies in Federal Taxation II*); Paul, *Studies in Federal Taxation* (3d ed. 1940) (hereinafter Paul, *Studies in Federal Taxation III*).

[FN56]. Cross, *Political Science and the New Legal Realism: A Case of Unfortunate Interdisciplinary Ignorance*, 92 Nw. U. L. Rev. 251, 271 (1997).

ABA-SCTTAX CH I.A

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The Supreme Court's Federal Tax Jurisprudence

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## Ch. I. Tax Principles Addressed and the Interpretive Context

**\*13** I.B. Statutory Interpretation and Construction in the United States

This book is based on the view that tax is too much cut off from the general law. Therefore, the methods of interpreting a specific statute like the Code should not be examined without reference to, or at least a general understanding of, the much more widely discussed issues of statutory interpretation in general. Outside of tax this subject has enjoyed great attention in the academic press, and to some extent in the general press, due to the perceptions that underlying political, social and economic forces are at work in schools of statutory interpretation.

I.B.1. *The Ideologies of Statutory Interpretation*

Statutory interpretation, like all of the law, mediates between multiple competing forces in society. Those seeking stability want the law interpreted literally; those seeking change attempt to find some component of law (including **\*14** the Constitution) that can be interpreted based on its purpose. The Bible suggests that the ox may be pulled from the ditch on the Sabbath, despite a general prohibition against work on that day. [FN57] Justinian forbade the writing of commentaries on the Corpus Juris because he thought they would unsettle the law. [FN58] However:

The object which he [Justinian] aimed to accomplish was neither attainable nor desirable. To enforce any system of law it is necessary to find out what the system is, to ascertain its meaning, to interpret and expound it. Ambiguities of language are unavoidable, even in the most carefully constructed documents. Even if the language is unambiguous in itself, its application to new circumstances and conditions will involve uncertainties and queries. [FN59]

More recently Professor Elhauge refreshingly rejected over emphasis on the words of the statute:

Under this argument, interpreters should generally try to interpret statutory ambiguities in the most numbskull way possible because that is more likely to deviate from legislative preferences and provoke textual specification. [FN60]

Generally taxpayers are not allowed to resort to purpose and so are forced to rely on text; that leaves the government to more frequently rely on purpose in tax cases. This has tended to produce a role reversal in the judiciary, leading even conservative judges, like Justice George Sutherland who led the Court's opposition to New Deal legislation, to adopt purposive interpretations of the Code in favor of the government, as in his unanimous opinion for the Court in *Gregory v. Helvering*. But before examining the Court's principles of Code interpretation, it is necessary to understand the broader context of statutory interpretation in the United States.

*I.B.1.a. Purposivism and Textualism and Tax*

Many legal academics have shown that the federal courts' styles of statutory interpretation have changed over time, as outlined below, fluctuating between emphasis on text (“textualism”) and emphasis on considerations beyond text (generally referred to as “purposivism,” but also by other terms). Tax practitioners tend to be ignorant of those changes, [FN61] but need to understand the outlines of the academic debates to avoid being dismissed as mere practitioners (an odd status, given the fact that no one is more interested in the subject \*15 matter than a practitioner of the subject).

The core Supreme Court tax opinions of the late 1930's and 1940's fit squarely into the then dominant view of the federal courts as collaborators with Congress in carrying out Congress' purpose behind the tax laws (purposivism). That view waned after 1960, about the same time the tax specific doctrines came into vogue in the lower federal courts' tax opinions, using citations to the Supreme Court opinions of the 1930's and 1940's. This flowering of the tax specific doctrines is somewhat counter to the rise of emphasis on a statute's text rather than its purposes (textualism) in the courts after 1960, and is best explained by the shift of the Tax Court from textualism toward purposivism just as the rest of the law was moving in the other direction. The appellate courts took their cues from the Tax Court, at least in the area of “tax shelters,” with a strong assist from Judge Learned Hand in his Second Circuit tax opinions.

*I.B.1.b. Interpretational Shifts over Time*

Academics view the general jurisprudence of law in the United States as having undergone a four phase maturing process over the last 150 years, [FN62] going from (1) the traditional school of formalism or doctrinalism that focused on relatively immutable legal principles and centered around the Harvard Law School of the late 1800's, to (2) the “legal realists” at Yale and Columbia in the 1920's and 1930's, who asserted that law was not rules but was what the judges do, [FN63] to (3) the Hart and Sacks school of “legal process,” [FN64] which attempted to reinvigorate doctrinalism by purifying the processes by which law was announced, to (4) the currently popular “critical legal studies” school, which focuses on those social forces and power centers and interest groups \*16 that affect what the law is. [FN65] Perhaps a fifth phase is “new legal realism,” which would apply more rigorous interdisciplinary tools to legal realism, [FN66] or legal pragmatism. [FN67] These lists overlooked the “grand style” exemplified by Chief Justice's Marshall's seminal writings. [FN68]

Professor Popkin (a tax professor) has ably charted in another way the shifts in courts' approaches to statutory interpretation. [FN69] He shows that the courts in the 1800s generally addressed statutory issues in the context of the dominance of the common law; statutes ordinarily were not viewed as creating systems of laws so much as remedies for defects in the common law. [FN70] The courts' view of statutes shifted roughly during the period 1900-1960 because (1) the dominance of the common law was waning, [FN71] (2) statutes were becoming more numerous and important to the industrialized society, (3) legislatures were viewed as more competent to enact needed laws in general, (4) the New Deal Congresses in particular were viewed positively, and (5) the federal courts in effect wanted to collaborate with Congress in carrying out its purposes. [FN72] After 1960 faith in legislation is thought to have waned, due perhaps to a distrust of the political process. [FN73] This shift is one explanation for the relative increase in judges claiming to be textualists rather than purposivists; [FN74] textualism actually reflects pessimism about judging as well as about legislation. [FN75]

*\*17 I.B.1.c. The Current Debates and Emphasis on Textualism*

There are many views of how courts work and decide cases today. For example, social scientists can show that

judicial attitudes are far more likely to determine legal outcomes than legal precedents. [FN76] There is a view that doctrines and maxims cited by court, including particularly the Supreme Court, are just covers for decisions already made on other grounds. [FN77] Indeed, the faith of most lawyers in the motive force of their arguments has been called a “mass delusion.” [FN78] Most academic discussions of various kinds of taxes and tax rules tend to start from premises that are largely alien to practicing lawyers (formalism or utilitarianism, etc.). There are schools even more unusual. [FN79] There is a school of thought that assumes that in the hard cases the courts have to resort to the judge's own best judgment, sometimes more charitably called pragmatism. [FN80] One noted academic has stated that if you don't analyze tax law on a welfarist/efficiency basis (which this book does not) you will be marginalized. [FN81]

In response to the increasingly strict or legalist construction of statutes exhibited by the Supreme Court, the academic community has taken a great interest in statutory interpretation. [FN82] Profs. Sunstein and Vermeule have catalogued the state of the debate as ricocheting among three poles: reliance on text, reliance on legislative purpose as informing text, and license to fill gaps in text (or even to deviate from text) without regard to legislative purpose, \*18 based on other values. [FN83] The academic literature places the Supreme Court squarely in the strict construction/purpose camp by the late 19<sup>th</sup> Century. [FN84] Sunstein and Vermeule explain that currently courts are seen as in fact pursuing a “new textualism,” [FN85] while Eskridge and Frickey advocates a dynamic interpretation of statutes to update them to modern meanings and needs, rejecting formalistic reading of words original meanings and emphasis on original intent, which they call practical reasoning. [FN86] Prof. Popkin calls the current trend ““pragmatic.” [FN87]

Judge Posner takes a different view. He endorses more emphasis on the practical consequences of decisions, starting with active reimagination of what the original enactors would have done with the current case (like Blackstone), [FN88] but when that fails, moves on to relatively unbounded judicial rule making based on the desirability of results (like Hart). He justifies this freedom in part by the failure of Congress to legislate clearly. However, one must acknowledge that it is hard to know which is the cause and which is the effect: Congress does not legislate clearly so judges must step in, or Congress knows that judges will step in and so do not legislate clearly?

Academics long ago began to denigrate the role of the law itself in judicial decision making. That role is called “legalism,” which may be viewed either aspirationally (as in the view that judges should follow the law, which academics refer to as a “normative” theory), or descriptively, as in the view that \*19 judges do follow the law (which academics refer to as a “positive” theory). [FN89] Judge Posner says of the legalist theory:

Legalists acknowledge that their methods cannot close the deal every time. That is an understatement. . . . Yet the existence of a solid legalist core in judicial decision making even at the highest levels must not be overlooked. . . . The percentage [36% from 1995-2005] of the [Supreme] Court's decisions that are unanimous might seem to place an upper bound on legalism in the Court. [FN90]

Posner describes as fruitless the search for “legalist meta-rules” as a response to ambiguity in the law; he cites as an example the “rule” that the constitution must be strictly construed. [FN91] He decries such rules because they must be posited, they cannot be deduced. They represent policy choices, “and policy choices so unsatisfactory that as a result there are no consistent legalists . . . in the judiciary, as distinct from the academy, where [referring to the academy] reality does not constrain imagination.” [FN92] Posner goes so far as to denigrate the very process by which administrators are forced to interpret the law (although addressing the parallel process applied by judges):

. . . Interpretation is a natural, intuitive human activity. It is not rule-bound, logical or step-by-step. It is pos-

sible to *impose* a rule . . . but [t]he procedure is spurious. It might make sense if legislators or the drafters of constitutions were committed to the canons of construction, but they are not, . . . and if in addition the legalist judge-interpreter felt bound only by substantively neutral canons . . . as distinct from substantive canons. . . . [FN93]

In effect Posner opposes not only meta-rules but the very process of trying to decide cases in an orderly fashion using accepted methods of fact finding and statutory interpretation and construction. In contrast this book assumes that a step by step process is at least useful in reminding us of all available steps.

Sunstein and Vermeule believe that most of the foregoing approaches err in failing to take account of institutional needs, for example by failing to plan for second best alternatives. They come down on the side of formalism, which they define as sticking close to the surface meaning of the texts, where possible, generally avoiding purposive readings, and placing great emphasis on the institutional need to promote clarity in the law. [FN94] They posit that due \*20 to their institutional expertise administrative agencies may be given broader range to make law than courts. [FN95] On the other hand Professor Barker has written a very insightful article that reaches many of the same conclusions as this book, but concludes that interpretation of the Code must be expansive because in 1913 Congress and the People decided they wanted an expansive income tax. [FN96] This assumes an overarching interpretational rule, which this book shows (perhaps unfortunately) does not exist.

Thus the grand choices laid out by academics currently appear to be formalism and textualism, purposivism, and some amalgam leaning toward formalism but striving to make the law clear with an eye to institutional needs and capabilities. An example of extreme purposivism is the Uniform Commercial Code, which contains important statements of its own purposes to be followed by all users. [FN97]

There is a huge disconnect between these academic debates and the conduct of the real users of judicial opinions, including principally the public and other government employees such as the Service. [FN98] Busy judges are going to do what judges do, without too much analysis of the processes that they intuitively apply. Thus, when they apply the tax specific doctrines they may be doing no more than applying some law school rule they long ago learned, such as the canon that a literal interpretation will not be adopted if the result would be an absurdity so gross as to shock the moral sense, which shock presumably derives from a sense of how the Congress' purpose would be subverted by the literal reading. [FN99]

#### I.B.2. *Contrast Interpretation of U.S. Nontax Statutes*

Moving from an overview of interpretational methods to specific examples, it is important to understand that different types of statutes enjoy different interpretational approaches. [FN100] In contrast with the Code, some other statutory regimes enjoy some overarching interpretive presumptions or rules, which either have been written into them or reflect a long tradition extending back to the common law. The tax law has come to apply a broad interpretation of income and strict construction of deductions, but there is no general direction\*21 on interpretive issues either in the Code or in Treasury regulations. [FN101]

Sometimes statutory regimes apply certain interpretive presumptions for reasons of public policy and legislative intent: most importantly, public policy requires that penal statutes be strictly construed against the government; legislative intent requires that statutes remedying defects in the common law be liberally construed to carry out the legislative purpose; statutes that affect commercial transactions reflect a concern with the intention of the parties. The Supreme Court has construed various parts of the federal Bankruptcy Code to maximize the coverage of the bankrupt estate and of the bankruptcy discharge, based on Congress' intent. [FN102]

In contrast to the approach to taxes, an important anti-government presumption founded on Congress' purpose applies in the construction of the Sherman Antitrust Act of 1890. The statute declares illegal *every* contract in restraint of trade and *every* attempt to monopolize any part of interstate commerce. The government sought to break up such a contract and attempt to which Standard Oil and others were parties. The trial court agreed, as did the Supreme Court in *Standard Oil*. [FN103] But the Supreme Court took the opportunity to construe the Sherman Act to apply only to “unreasonable” restraints of trade. [FN104] This decision was widely criticized, but defended on the basis of Congress' purpose to adopt the common law tradition. [FN105] Nevertheless, just as the application of “substance over form” is episodic in the tax law, “rule of reason” is episodic in the federal law generally. [FN106]

\*22 As another example, the courts early adopted a nuanced approach to application of the usury statutes, which bear an important resemblance to taxing statutes. The courts construed the usury statutes strictly because they principally imposed penalties. [FN107] But in identifying the contract and the interest, the courts employed the liberal rules of equity to find a loan that the parties tried to obscure, as discussed in Ch. V.E.1.c., below.

Contract law has always looked to the intent of the parties. The Uniform Commercial Code [FN108] section 1-103 states: “The Uniform Commercial Code must be liberally construed and applied to promote its underlying purposes and policies, which are: (1) to simplify, clarify, and modernize the law governing commercial transactions; (2) to permit the continued expansion of commercial practices through custom, usage, and agreement of the parties; and (3) to make uniform the law among the various jurisdictions.” But in practice the UCC has had to back away from reliance on standards and to add formalities and more specific rules. [FN109]

The Sales chapter of the UCC was famously built upon principles of fair dealing in interpretation. This can be traced back to the principle of *bona fidei* (obligations of good faith) that the Roman Corpus Juris applied to most bilateral contracts:

[In contrast to delict obligations, which were strictly enforced, the reciprocal and consensual contracts]. . . were bona fidei (obligations of good faith) . . . And these services and duties were often of such a nature that they could not be distinctly foreseen or explicitly provided for in the contract. They must depend in part on custom, in part on tacit understandings, above all on the obvious requirements of fair and honorable dealings, that is on bona fides. This bona fides, this subjection to equity and reason, was an actual element in such contracts. . . . [FN110]

This brief review of other statutory regimes suggests that (1) codes or groups of statutes can have interpretive guides, which are usually (2) built on the well understood fundamental roles of the statutes, and (3) have some legislative imprimatur or long acceptance. As shown below, the revenue Code both has no well understood role and no clear interpretive doctrines.

### \*23 I.B.3. *Contrast Other Countries*

American courts generally and historically have fallen on the substantive end of the substantive versus textual spectrum along which courts may interpret statutes. That is, United States courts exercise more interpretive discretion than our closest legal brethren in British courts, as well as the courts of many other western countries; and the Supreme Court has not heavily relied on British case law in tax. [FN111] Perhaps the American difference explains why the U.S. tax system has so far resisted adoption of a general anti-abuse rule (GAAR), such as many other countries' tax Codes have adopted. [FN112]

Internationally the form versus substance dichotomy describes contrasting methods of statutory construction

that tend to be true throughout a nation's legal system: the rules based, formal, literal approach of a formal system of law versus the search for reasons of substance underlying a statute where lower “content formality” and “rank formality” are accorded the statute. [FN113]

British courts historically have tended to read statutes in a more formalistic manner, [FN114] while American courts historically have tended to rely more heavily on substantive reasoning. These tendencies have been explained as logical reactions to the broader political contexts in which the two court systems have operated:

- In Britain, courts have more reason to expect that an “unfair” result of a formal reading of a statute will receive fuller attention as a matter of law reform in Parliament, [FN115] as assisted by interested constituencies.
- In America, that expectation is less, for a variety of reasons, which promotes the desirability of solving the problem in the courts. [FN116]
- It is easier for Parliament to act than for Congress to act. [FN117]

\*24 Thus American judges tend to be willing to consider evidence of statutory purpose in deciding whether the words are unclear in the first place. [FN118] Perhaps another reason for this tendency is that American statutes tend to be incomplete upon enactment, due to the larger array of forces brought to bear on their enactment. [FN119] In contrast, British courts' emphasis on plain meaning is supported by these more granular considerations:

- greater confidence that proficient drafting will invest the statute with the legislative purpose;
- greater confidence in the ability of the legislature to remedy an unsatisfactory application of statute;
- greater reliance by British lawyers on plain meaning as properly effecting sensible interpretation;
- greater concern with the right of the citizen to rely on the statute;
- less belief that the courts should override the legislature; and
- the additional and unnecessary expense of determining the meaning of statutes beyond their face. [FN120]

Political scientists explain this difference as one of many indications that Americans distrust their government, as written deep in the Constitutional fabric through checks and balances, division of power and the like. [FN121] Such a view would explain the relative lack of formalism in American statutory construction as dictated by the nature of the country's traditions and institutions. [FN122] De Tocqueville attributed the substantial political power of American judges to their power to apply the Constitution to invalidate laws, contrasting both the French and the British systems. [FN123] Barker attributes the difference between the British and American approaches to a combination of factors related in part to the timing of the adoption of the income tax and the populist aspect of that movement. [FN124]

There also will be a linkage between a country's judicial view of agency regulations and its view of statutes: the more formal authority given to statutes the more controlling authority given to regulations and vice versa. Thus, British courts tended to impose a heavy burden on efforts to upend a regulation, whereas American courts historically asserted greater control over the \*25 regulations. [FN125]

But the American rule of flexibility is not solely due to substantive construction of formal rules. There are probably more rules in America that are inherently flexible, thus helping to acculturate the courts to substantive reasoning. [FN126] In the early 20<sup>th</sup> Century Roscoe Pound observed that American judges tended to treat statutes as general guides, a view that had wide observance. [FN127] Atiyah and Summers noted that John Adams, a distinguished lawyer before being president, argued against strict interpretation of statutes on the basis of a higher law of “God and Nature.” [FN128]

In a movement associated with Justice Holmes, by the end of the 19<sup>th</sup> Century law was viewed as separated from morals and religion, and more a matter of controlling statutes, no doubt aided by the more formalistic legal education then provided, and the needs of a growing economy for firm rules. [FN129] But at the same time Holmes ushered in the intense recognition that law is what judges do, [FN130] which turned into legal realism. [FN131] Of course realism is profoundly at odds with formalism. [FN132] Atiyah and Summers explain that formalism was tempered in America by the views that law was an instrument of social improvement and must be practically applicable (utilitarian). [FN133] Unfortunately, the liberation of American law from formalism by realism and utilitarianism left it without any coherent theory of substantive law to replace formal rules. [FN134]

Roscoe Pound attacked realism as a way of criticizing practically needed methods without offering any viable alternatives. For example, the fact that judges can be discerned to create law when they fit a statute to facts about which the legislature had no intent at all is true enough, but not helpful. Users of law demand certainty and judges demand some degree of latitude to do justice in particular cases. That judges strive to balance these needs through objective creation of presumed intent is:

. . . a “striving for the ideal [that] goes far to realize the ideal. It is the approximation to our ideal [of justice] which is significant, not the falling \*26 short . . . If a theory of social control [realism] through the force of political organization of society is made from the fallings short rather than from the achievements, we shall undo . . .” [the progress of civilization in law. [FN135]

*The Duke of Westminster's Case*. Because the law of other countries is not elsewhere addressed in this book, this is an appropriate place to acknowledge the British case that is commonly cited for British tax literalism: *CIR v. Duke of Westminster*, [1936] A.C. 1 (H.L.). That opinion allegedly took the British tax law away from rejecting sham transactions: It is often cited as the classic British example of the success of a factual sham. [FN136]

Unfortunately such “common knowledge” is not as clear as it is made out to be. The Duke's case was simply a fact finding case in which a divided court found the facts in a fairly ordinary way. The Duke could not deduct wages paid but could deduct annuities paid and had to withhold tax on the annuities. Thus he helped himself to a deduction by reformatting his wage payments as annuity payments. He won because the servants were *entitled to the annuities whether they worked or not*. This appears to be a substantive and not just a cosmetic variation.

Although the British courts now have made movements toward a harsher view of tax reduction planning, these changes have been in the realm of relaxing the strict construction of taxing statutes against the government, not of ignoring the legal effect of the facts of the case. [FN137]

[FN57]. *Exodus* 20:8-11.

[FN58]. Hadley, *Introduction to Roman Law* 20 (New York, Appleton 1893).

[FN59]. *Id.*; see also, Barker, *supra* note 21, at 870-73 (discussing similarity of Roman law purposivism).

[FN60]. Elhauge, *Preference-Eliciting Statutory Default Rules*, 102 *Colum. L. Rev.* 2162, 2275-76 (2002).

[FN61]. Cummings, *The Debate You Never Heard Of*, 2008 *Tax Notes Today* 166-24 (Aug., 26, 2008).

[FN62]. See Calabresi, *An Introduction to Legal Thought: Four Approaches to Law and the Allocation of Body Parts*, 55 *Stan. L. Rev.* 2113 (2003). Judge Calabresi describes the four approaches to law that have dominated the last century: (1) doctrinalism or formalism (Langdell/Harvard school), (2) functionalist or interdisciplinary, (3) legal process, (4) law and status or critical legal studies.

[FN63]. See Green, *Legal Realism as Theory of Law*, 46 *Wm. & Mary L. Rev.* 1915 (2005). The article observes that H.L.A. Hart made legal realism unfashionable by observing that the law must be more than just decisions; judges have to decide on some basis, which ultimately is guided by the law. This observation has to be true, and a rereading of Jerome Frank's, *Law and the Modern Mind* (Brentano's 1930) will convince the reader that the legal realists went too far.

[FN64]. Feldman, *The Transformation of an Academic Discipline: Law Professors in the Past and Future (or Toy Story Too)*, 54 *J. Legal Educ.* 471, 485 (2004) (Observed the shift from realism to emphasis on “legal process” in the writings of Hart and Sacks. He explains this as an attempt to bolster the traditional view by invoking reasoned analysis to prevent courts from being viewed as making arbitrary decisions, as the realists might imply.). But the Legal Process school may have come too late to impact the decline of purposivism and rise of textualism. See Popkin, *supra* note 8, at 147-49.

[FN65]. Feldman, *supra* note 64, at 487 (observing that critical legal studies tends to hark back to the realists, but differs from the realists in looking for interest groups and power centers that had their way with real life legal interpretation).

[FN66]. Macauley, *New versus Old Legal Realism: Things Ain't What they Used to Be*, 2005 *Wis. L. Rev.* 365. This article describes the progression from “traditional legal scholarship that focused on the logic of doctrine” and was reflected in the great Harvard written textbooks and Langdell type courses of the early part of the 20th Century (p. 369), to the legal realism school that developed mostly at Yale and Columbia in the '20's and '30's and basically observed that judges “make law” in the sense of bringing to their decisions views and information not found in the record and the formal law, to the “new legal realism” that basically attempts to put empirical analysis at the service of legal realism and let the chips fall where the may in terms of left versus right tilt, that critical legal studies might discern.

[FN67]. Posner, *How Judges Think* 230-65 (Harvard 2008).

[FN68]. See Llewellyn, *supra* note 53, at 396 (1950) (tracing how Marshall relied on principle over precedent, referred to as the Grand Style; then in the period of 1880-1910 the Formal Style depended more on precedent; thereafter the Grand Style began to creep back in).

[FN69]. Popkin, *supra* note 8.

[FN70]. *Id.* at 67, 112.

[FN71]. *Id.* at 126 (citing an important statement by Roscoe Pound in 1912 that the strict construction of statutes as in derogation of the common law was no longer appropriate).

[FN72]. *Id.* at 115-49.

[FN73]. *Id.* at 174.

[FN74]. *Id.* at Part III and Ch. 5.

[FN75]. *Id.* at 153; *see also id.* at 172 (stating that modern textualists are more concerned with limiting judging than deferring to the legislature); *id.* at 247 (summarizing the trends from common law to purposive interpretation to modern textualists who may think they have little to do as judged).

[FN76]. *See Cross, New Legal Realism, supra* note 56, at 251.

[FN77]. Martineau, *Craft and Technique, Not Canons and Grand Theories: A Neo-Realist View of Statutory Construction*, 62 *Geo. Wash. L. Rev.* 1, 37 (1993).

[FN78]. Cross, *New Legal Realism, supra* note 56, at 254.

[FN79]. *See, e.g., McCaffery, Tax's Empire*, 85 *Geo. L.J.* 70 (1996) (using as a model Ronald Dworkin's work).

[FN80]. *See, e.g., Cross, Statutory Interpretive Methodologies*, 81 *Notre Dame L. Rev.* 1971, 1977 (2007). Dworkin styles his approach to statutory interpretation as “integrity” in *Law's Empire* (Harvard 1986).

[FN81]. Bankman, *The Business Purpose Doctrine and the Sociology of Tax*, 54 *SMU L. Rev.* 149, 157 (2001).

[FN82]. For a review of the academic literature, *see Smith, The Deliberative Stylings of Leading Tax Scholars*, 61 *Tax Law.* 1 (2007); Smith, *Formulaically Expressing 21<sup>st</sup> Century Supreme Court Tax Jurisprudence*, 8 *Hous. Bus. & Tax J.* 37 (2007).

[FN83]. Sunstein and Vermuele, *Interpretation and Institutions*, 101 *Mich. L. Rev.* 885, 899-913 (2003). For other such surveys *see Aleinikoff, Updating Statutory Interpretation*, 87 *Mich. L. Rev.* 20 (1988). He states that Blackstone favored a so-called common law approach to statutory interpretation, which shared with the common law the characteristic of flexibility, based on seeking the lawmaker's actual or presumed purposes (“purposivism”) and avoiding absurd results; but in the “hard cases” Blackstone chose to hew to formalistic law if the only other option was to “do equity” on some policy grounds divorced from the statute's words and the legislative intent. His contemporary, Bentham, espoused a more formal and utilitarian approach, with greater emphasis on codification and, where that is lacking, judicial interpretive power unrestrained by concepts like pur-

posivism. *See also* Manning, *Textualism and the Equity of the Statute*, 101 Colum. L. Rev. 1, 7, 25 (2001) (ascribing belief in the equity of the statute to Blackstone); Cavanaugh, *Order in Multiplicity: Aristotle on Text, Context and the Rule of Law*, 79 N.C. L. Rev. 577 (2000) (also cataloguing the interpretive schools in the tax area).

[FN84]. Manning, *supra* note 83 at 103-04. This article examines another concept, the equity of the statute. It argues that that concept is yet another judicial strain that did not survive in the United States, whose courts focused more on the intent and purpose of Congress. Manning found that focus operative in the late 19th Century, but it did not mean that the Court was not focused on text.

[FN85]. *See, e.g.*, Solimine and Walker, *The Next Word: Congressional Response to Supreme Court Statutory Decisions*, 65 Temp. L. Rev. 425, 431 (1992).

[FN86]. Eskridge and Frickey, *Statutory Interpretation as Practical Reasoning*, 42 Stan. L. Rev. 321, 321 (1990).

[FN87]. Popkin, *supra* note 8, at 153 (Duke 1999).

[FN88]. But pinning down Blackstone's interpretive style is difficult. *See id.* at 19-22 (pointing out that he clearly put text ahead of “equity”).

[FN89]. Posner, *How Judges Think*, *supra* note 67, at 41 (Although Judge Posner is not an academic, he is an acute student of the academic thinking on judging, as reflected in his latest book, which discusses eight different ways of explaining why judges rule as they do, in addition to the law: attitudinal, strategic, sociological, psychological, economic, organizational, and pragmatic. (*Id.* at 19)).

[FN90]. *Id.* at 47-50.

[FN91]. *Id.* at 47-8.

[FN92]. *Id.* at 48.

[FN93]. *Id.* at 193.

[FN94]. Sunstein and Vermeule, *supra* note 83, at 921.

[FN95]. *Id.* at 928.

[FN96]. Barker, *supra* note 21, at 873-80.

[FN97]. See McDonnell, *Purposive Interpretation of the Uniform Commercial Code: Some Implications for Jurisprudence*, 126 U. Pa. L. Rev. 795, 797-98 (1978). Even by 1978 the author was able to say that the purposive effort had failed to the significant extent that some courts would not embrace it, but remained positive on the purposive approach. See *infra* Ch.VI.B.1.d.

[FN98]. Other federal judges, of course, are also a constituent user group, but a very small one on a relative basis. There are only about 800 Article III judges, and 1200 including senior status judges. See Posner, *How Judges Think*, *supra* note 67, at 60.

[FN99]. Murtagh, *The Role of the Courts in the Interpretation of the Internal Revenue Code*, 24 Tax Law. 523, 524 (1970) (not referring to the doctrines).

[FN100]. See, e.g., Oei, *Context Matters: The Recharacterization of Leases in Bankruptcy and Tax Law*, 82 Am. Bankr. L.J. 635, 656 (2008).

[FN101]. I.R.C. § 7806. “Construction of Title” is the closest provision in the Code to this proposal and it only identifies some interpretational doctrines *not* to use (no inference from Code arrangement, classification, titles). See further discussion *infra* Ch. VI.B.1.a. The Bankruptcy Code, Title 11 of the U.S. Code, also contains no rules of construction.

[FN102]. See, e.g., *Kokoszka v. Belford*, 417 U.S. 642 (1974) (construe property of the estate generously); *Callaghan v. Reconstruction Fin. Corp.*, 297 U.S. 464 (1936) (strict allowance of trustee's commissions); *Local Loan Co. v. Hunt*, 292 U.S. 234 (1934) (precluding creditor from access to debtor's funds outside bankruptcy); *Williams v. U.S. Fid. & Guar. Co.*, 236 U.S. 549 (1915) (discharge generously construed).

[FN103]. The *Standard Oil Co. v. United States*, 221 U.S. 1 (1911); see also, Atiyah & Summers, *Form and Substance in Anglo-American Law: A Comparative Study of Legal Reasoning, Legal Theory, and Legal Institutions* 77 (Clarendon Press 1987) (citing this decision as a prime example of the American courts' tendency to take a hard and fast rule and turn it into a flexible rule as applied).

[FN104]. The Court reasoned that the English common law enforced a similar rule where the restraint was unreasonable, thus implying a wrongful purpose; that some courts in this country had followed that view; that Congress wrote the Sherman Act in light of the context of the times and those judicial interpretations; that Congress must have contemplated the exercise of judicial discretion and restrain in enforcing the Act, because it used such broad terms (every contract), which would have been imprudent given the impossibility of foreseeing the new forms contracts and monopoly attempts might take; therefore, Congress contemplated and intended the standard of reason. See *Standard Oil*, 221 U.S. at 1.

[FN105]. Taft, *The Anti-Trust Act and the Supreme Court*, 114-15 (Harper 1914).

[FN106]. *Cf. Chicago, Burlington & Quincy Ry. Co. v. United States*, 220 U.S. 559 (1911) (refusing to read a negligence requirement into the federal Safety Appliance Act making railroads liable for not having certain equipment meeting specific standards).

[FN107]. *Lake Benton First Nat. Bank v. Watt*, 184 U.S. 151 (1902) (stating that federal usury statute was penal); Webb, *Treatise on the Law of Usury* 230 (St. Louis, The F. H. Thomas Law Book Co. 1899) (discussing rule of liberal construction to avoid finding usury); On Usury, 1 Al. L.J. 431, 433 (1870).

[FN108]. *See generally* Breen, *Statutory Interpretation and the Lessons of Llewellyn*, 33 Loy. L.A. L. Rev. 263 (1999). Breen describes how Llewellyn wrote tools into the first drafts of the U.C.C. for interpreting the contract but not the statute, for which he proposed a “four corners” approach. He did not want resort to legislative history because he *did* want the statute to be flexible, and not bound to its original intent. The author argues for contextualism in interpreting statutes.

[FN109]. Litowitz, *Perspectives on the U.C.C.* (Carolina Academic Press 2001); Maggs, *Karl Llewellyn's Fading Imprint on the Jurisprudence of the Uniform Commercial Code* 71 U. Colo. L. Rev. 541, 559-64 (2000).

[FN110]. Hadley, *supra* note 58, at 255-56.

[FN111]. *See, e.g., Merchant's Loan & Trust Co. v. Smietanka*, 255 U.S. 509 (1921) (finding that the British income tax statutes are so different that they are quite without value in construing the tax statutes).

[FN112]. *See* Edgar, *Building a Better GAAR*, 27 Va. Tax Rev. 833 (2008). The Treasury has suggested that the absence of a GAAR in the U.S. is attributable to the greater willingness of the U.S. courts to create judicial doctrines. *Treasury White Paper on Corporate Tax Shelters (Part 2) supra* note 10, at VIB. Some other countries do have such general rules. *See* Int'l Fiscal Assoc., *Form and Substance in Tax Law*, Vol. LXXXVIIa, 50 (Kluwer 2002).

[FN113]. *See generally* Atiyah and Summers, *supra* note 103, at 20. *See also* Cunningham and Repetti, *supra* note 13, at 23 (discussing Atiyah and Summers' observations).

[FN114]. Barker, *supra* note 21, at 828-30 (2003); *see Treasury White Paper on Corporate Tax Shelters supra* note 10. This includes not relying on legislative history. *See Commissioner v. Acker*, 361 U.S. 87 (1959) (Frankfurter, J., dissenting).

[FN115]. Burgess, *Form without Substance? A Comment on Tax Avoidance and its Influence on Interpretation of Tax Statutes*, 1982 Statute L. Rev. 87, 88 (1982) (“The traditional British approach to the problem of tax avoidance is to attack it legislatively. . .”).

[FN116]. Atiyah and Summers, *supra* note 103, at 29-30, 37, 100-01; see Gunn, *Some Observations on the Interpretation of the Internal Revenue Code*, 63 Taxes (CCH) 28 (1985) (reminding the tax bar to avoid wooden interpretations, in contrast with British approach).

[FN117]. Elhauge, *supra* note 60, at 2223.

[FN118]. Atiyah and Summers, *supra* note 103 at 102 (citing as an example the dissents in *United States v. Locke*, 471 U.S. 84 (1985)).

[FN119]. *Id.* at 307 (citing Posner, *The Federal Courts: Crisis and Reform* 19 (Harv. U. Press 1985)).

[FN120]. *Id.* at 104-05.

[FN121]. *Id.* at 40.

[FN122]. *Id.* at 41.

[FN123]. De Tocqueville, *Democracy in America* Ch. 6 (Harvey C. Mansfield & Delba Winthrop, eds., Univ. Chicago Press 2000) (1835, 1840).

[FN124]. Barker, *supra* note 21, at 832.

[FN125]. Atiyah and Summers, *supra* note 103, at 61. However, Atiyah and Summers, writing just two and a half years after the *Chevron* opinion (discussed *infra* Ch. VI.D.), missed it, and cited the Davis treatise for the prevalent and appropriate substitution of judicial for administrative judgment in America in the 1980's.

[FN126]. *Id.* at 75-6.

[FN127]. *Id.* at 88 (quoting Pound, *The Scope and Purpose of Sociological Jurisprudence*, 25 Harv. L. Rev. 489, 515 (1912)).

[FN128]. *Id.* at 234.

[FN129]. *Id.* at 246-47.

[FN130]. Holmes, *The Path of the Law*, 10 Harv. L. Rev. 457, 461 (1897).

[FN131]. *See* Frank, *Law and the Modern Mind* (Brentano's 1930); Popkin, *supra* note 8, at 144-47 (stating that the realists were supporters of collaborative purposivism by judges).

[FN132]. Atiyah and Summers, *supra* note 103, at 255.

[FN133]. *Id.* at 256.

[FN134]. *Id.* at 262-63 (also noting that the most recent movement, critical legal studies, has not produced any constructive theory).

[FN135]. Pound, *Administrative Law* 99-100, 132 (Univ. of Pittsburgh Press 1942).

[FN136]. *See, e.g.*, Sheppard, *China Tries a GAAR*, 123 *Tax Notes Int'l* (TA) 523 (May 4, 2009).

[FN137]. Burgess, *supra* note 115, at 88 (“The traditional British approach to the problem of tax avoidance is to attack it legislatively. . .”); McLeod, *supra* note 9, at 381; comments of Donald Korb in 85 *Taxes* (CCH) 73, 81 (2007).

ABA-SCTTAX CH I.B

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