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Tax Shelters and the Code: Navigating between Text and Intent

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TABLE OF CONTENTS

I. INTRODUCTION

Tax shelters raise difficult problems of statutory interpretation. In her interesting article, *Of Lenity,* Chevron, *and KPMG,*[1] Kristin

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We wish to thank the participants in the University of Minnesota Tax Shelter symposium for valuable comments, and the Federalist Society, which sponsored the symposium. We are also grateful to Kristin Hickman and Michael Schler for their helpful comments and to Rachel Ehrhardt for her valuable assistance as a research assistant on this project. This paper was supported by the Dean's Summer Research Stipend program at Brooklyn Law School.

[1] Kristin Hickman, *Of Lenity,* Chevron, *and KPMG,* 26 VA. TAX REV. 905 (2007).

Hickman explores one of them: the recent tendency of courts to apply the rule of lenity in civil cases, potentially leading to a narrow interpretation of the Internal Revenue Code (Code) that would undermine efforts to collect the taxes that Congress intended to impose.[2] We agree both with Hickman's articulation and analysis of this problem. In this commentary, we situate more broadly the status of tax shelters in the jurisprudence of statutory interpretation. More specifically, we show how tax shelters are a challenge to ordinary principles of statutory interpretation, whether or not lenity is expanded to make it even more difficult to combat them.

Scholars and judges have made a great deal over various differences in judicial philosophy in statutory interpretation. Most notable is the rift between those who claim to be textualists and those who advocate for more contextual analysis.[3] We acknowledge these differences, but believe that the problem of tax shelters would exist, more or less in the same form, regardless of how judges approach statutory interpretation.

At bottom, there is relatively strong consensus that the goal of statutory interpretation is to find and enforce the intended meaning of the legislature and that the best evidence of this intent is the language of the statute. Tax shelters take advantage of this consensus approach in two distinct ways. First, tax shelters take advantage of the flexibility of statutory words by structuring transactions that arguably come within statutory language that would license the avoidance of taxation, albeit in a non-prototypical sense. Second, tax shelters take advantage of gaps in legislation, where at most there is unexpressed legislative intent. Such gaps are an especially difficult problem because few, if any, statutory interpreters are comfortable construing a law beyond *any* fair meaning of its text.

Often, tax shelters can be characterized either way. Although they appear quaint by today's standards, it may be helpful to begin by remembering an older generation of tax shelters. A typical example

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[2] The rule of lenity is the name given to the principle that "penal statutes should be strictly construed against the government or parties seeking to enforce statutory penalties and in favor of the persons on whom penalties are sought to be imposed." NORMAN J. SINGER, STATUTES AND STATUTORY CONSTRUCTION 59.03 (6th ed. 2002).

[3] Most relevant here is Noel B. Cunningham & James R. Repetti, *Textualism and Tax Shelters*, 24 VA. TAX REV. 1 (2004). For an illustration of the stark contrast between these approaches, compare WILLIAM N. ESKRDIGE, DYNAMIC STATUTORY INTERPRETATION (1994) with ADRIAN VERMEULE, JUDGING UNDER UNCERTAINTY (2006).

might involve a passive investment by a lawyer or a doctor in an orange grove.[4] That investment would be motivated purely by the availability of tax benefits that participating taxpayers could use to "shelter" their professional income from taxation. One could frame the problem posed by such a tax shelter as a failure of a hypothetical statute to limit the sought-after tax benefits to "legitimate" farmers.[5] That failure could be a result of a gap in the underlying statute (e.g. the statute was created with farmers in mind, but fails to incorporate such a limitation) or of ambiguity in that statute (e.g. the statute limits the benefits to farmers, but employs a definition of farmer that could be interpreted either to include or exclude passive investors such as doctors and lawyers). In practice, the statutory vulnerability is likely to fall somewhere between a distinct gap and a straightforward ambiguity. For instance, the statute might explicitly refer to farmers, but provide no definition of the term. A court could invalidate such a shelter by filling the gap or by resolving the ambiguity against the taxpayer, declaring that Congress would not have intended the doctor in question to be treated as a farmer.

Alternatively, if courts were unwilling or unable to do either, Congress or perhaps the Treasury Department could intervene to prevent future revenue losses. They could do so by (i) specifying the characteristic (in this instance a lack of active participation in the orange grove's business so that the taxpayer is essentially purchasing tax benefits) that makes the doctor's ability to derive the unintended tax benefits "abusive" and (ii) using that characteristic to limit the availability of those benefits accordingly.[6]

Legislative or administrative action after the fact, however, is a second best solution in many cases, since it assumes a safe harbor for some period of time before the new laws are put in place.[7] Thus, if these sorts of shelters are to be rendered ineffective, principles

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[4] *See* Michael Livingston, *Congress, the Courts, and the Code: Legislative History and the Interpretation of Tax Statutes*, 69 TEX. L. REV. 819, 840 (1991).

[5] Such "legitimate" farmers might include a farmer who also operates a gas station, but not a doctor who never lays eyes on the orange grove in question. *Id.*

[6] Congress did precisely that by creating the passive activity loss rules. I.R.C. § 469. The passive loss rules prevented tax losses incurred in a passive investment from sheltering active income.

[7] *See* Marvin A. Chirelstein & Lawrence A. Zelenak, *Tax Shelters and the Search for a Silver Bullet*, 105 COLUM. L. REV. 1939, 1950 (2005) ("It is always possible, of course, to shut down particular shelter techniques with narrowly-targeted legislation. . . . The problem is that these targeted fixes are always made prospective only. As Congress closes one loophole, tax shelter designers find other glitches in the Code around which to build new shelters.").

beyond the interpretation of the language of the particular sections of the Code that govern the type of transaction in dispute must be invoked.[8] Hickman provides illustrations of both gap- and ambiguity-based tax shelters in her discussion of the KPMG case, and we will use her illustrations, among others, to make our points.

II. BETWEEN LANGUAGE AND INTENT: WHERE TAX SHELTERS RESIDE

For purposes of this essay, we adopt the position, taken by others, that tax shelters are generally characterized as transactions that appear to comply in a literal manner with the Code, but which are designed to reach a tax result that Congress would not have intended.[9] Transactions that take advantage of rules that intend to give favorable treatment, such as deducting mortgage interest on a principal place of residence,[10] are typically not considered to be tax shelters.[11] Nor are transactions that intentionally disobey the law. These constitute tax fraud.[12] Tax shelters, in contrast, involve the structuring of

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[8] For this reason, we support the use of anti-abuse provisions to defeat tax shelters, not only as a good idea, but probably as the only workable means of shutting down tax shelters that fly in the face of congressional intent. In other words, "[w]hat is wanted is a silver bullet (or perhaps a broad-spectrum antibiotic) that would kill a wide variety of tax shelters, and do so in such a way that the government would no longer always be playing catch up. . . ." *Id.* at 1951 (suggesting a provision that would "disallow noneconomic losses and noneconomic deferrals through the use of foreign (and other tax-indifferent) counterparties"). *Id.* at 1952. As Chirelstein and Zelenak explain, the passive activity loss rules introduced in the 1980s in response to an earlier wave of tax shelters provide an example of a successful anti-abuse provision. *See* I.R.C. § 469 (preventing passive investment losses from offsetting active business income).

[9] Cunningham & Repetti, *supra* note 3, at 20; Michael L. Schler, *Ten More Truths About Tax Shelters: The Problem Possible Solutions, and a Reply to Professor Weisbach*, 55 TAX L. REV. 325, 331 (2002) (responding to David A. Weisbach, *Ten Truths About Tax Shelters*, 55 TAX L. REV. 215, 218 (2002)).

[10] I.R.C. § 163(h)(3).

[11] *See* David P. Hariton, *Response to "Old 'Brine' in New Bottles" (New Brine in Old Bottles)*, 55 TAX L. REV. 397, 402 (2002) (responding to James S. Eustice, *Abusive Corporate Tax Shelters: Old "Brine" in New Bottles,* 55 TAX L. REV. 135 (2002)). Hariton illustrates this principle by distinguishing between leveraged leases and lease-in, lease-out, or LILO, tax shelters: "The former passes legitimate tax benefits that have been conferred by Congress for investment in U.S. business property from one taxpayer to another . . . whereas the later [sic] purports to create tax benefits that Congress did not intend to confer on anyone. . . ." *Id.* at 402.

[12] *See* I.R.C. § 7201 (treating efforts to "willfully . . . evade or defeat" income taxes as felonies).

transactions to appear lawful while thwarting the intent of the legislature.

Which such devices should be allowed as a substantive matter is not a question of statutory interpretation, as Professor Weisbach points out.[13] Nonetheless, if the successful tax shelter must at least arguably comply with the Code and regulations, then it must do so in light of the various tools that courts use to determine the scope of statutes and regulations. The planner must structure the transaction to withstand judicial scrutiny despite the fact that those who wrote the law would likely have intended a different result.

A crucial question, then, is to what extent the courts take heed of the intent of the legislature in the interpretation of statutes. If courts did so to the exclusion of all other considerations, then tax shelters would never succeed. If, in contrast, legislative intent were irrelevant, they would always succeed. The reality lies somewhere in the middle. Courts are generally quite concerned with discovering and enforcing the will of the legislature. They are not in agreement, however, about what evidence of legislative intent is legitimate to consult, and legislative intent is not the only value to which they adhere. Other values, such as deference to administrative agencies — including the Internal Revenue Service (Service) — and fair notice — which underlies the rule of lenity — also play a role. These are the principles upon which Hickman relies in her analysis of tax shelters. We return to them in Part IV. First, we explore briefly the role that legislative intent plays in the interpretation of statutes.

Nearly all judges, even textualist judges who profess otherwise, attempt to ascertain the intent of the legislature and to apply the statute in a way that will further that intent. In fact, a Lexis survey of judicial decisions from the 1990s found that federal courts used *intent* and related words (i.e., *intention, intend*, etc.) within six words of *Congress* or *legislature* more than 3000 times each year during the decade, and that state courts did the same.[14] That amounts to a minimum of 60,000 instances in a ten-year period.

How do courts find legislative intent? They look first to the language of the statute. For example, in an opinion construing the innocent infringer provision of the Lanham Act, the Fifth Circuit

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[13] Weisbach, *supra* note 9, at 218 (suggesting disputed interpretive doctrines, such as substance over form, could simply be codified to alleviate separation of powers concerns).

[14] Lawrence M. Solan, *Private Language, Public Laws: The Central Role of Legislative Intent in Statutory Interpretation,* 93 GEO. L.J. 427, 453–54 (2005).

wrote, "Our starting point in divining the meaning of a statute is the intent of Congress. The best evidence of this intent is the language of the statute."[15] Pronouncements relating language and legislative intent are easy to find in judicial opinions.[16]

This does not end the inquiry, however. It only begins to define it. Once language comes into play, judges do not always agree upon where ambiguities lie and how to resolve them. Consider *Smith v. United States*,[17] a case widely discussed in the scholarly literature on statutory interpretation.[18] In that case, the defendant had attempted to trade an unloaded machinegun for illegal drugs and was prosecuted for attempting to "use a firearm . . . during and in relation to a drug trafficking offense."[19] A majority of six justices voted to affirm the conviction, based on the meanings of the words as revealed in a host of dictionaries, the relationship between the statute at issue and related statutes, and the likely intent of the legislature based on the proliferation of guns. The majority correctly found that the act of trading a firearm for drugs can properly be seen as using the firearm.

Justice Scalia dissented, arguing that the "ordinary meaning" of "use a firearm" means to use it *as* a firearm, not merely as a thing of value.[20] He, too, was correct. When we use the expression "use a firearm" we typically have in mind using it for its intended purpose. *Smith* illustrates an important point. Both the majority and dissent claimed fidelity to the intent of the legislature.[21] They both sought to discover that intent from the language of the statute. Yet they

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[15] Dial One of the Mid-South, Inc. v. Bellsouth Telecommunications, Inc., 269 F.3d 523, 525 (5th Cir. 2001).

[16] *See, e.g.*, Lamie v. United States Tr., 540 U.S. 526, 534 (2004) ("The starting point in discerning congressional intent is the existing statutory text, not predecessor statutes"); Steadman v. SEC, 450 U.S. 91, 97 (1981) ("The search for congressional intent begins with the language of the statute").

[17] 508 U.S. 223 (1993).

[18] *See, e.g.*, Ellen P. Aprill, *The Law of the Word: Dictionary Shopping in the Supreme Court*, 30 ARIZ. ST. L.J. 275, 319 (1998); Cunningham & Repetti, *supra* note 3, at 15–16.

[19] 18 U.S.C. § 924(c)(1) (2006).

[20] *See* 508 U.S. at 242 (Scalia, J., dissenting).

[21] *See id.* at 229 (majority opinion) ("Had Congress intended the narrow construction petitioner urges, it could have so indicated. It did not, and we decline to introduce that additional requirement on our own."); *see also id.* at 236 (Scalia, J., dissenting) ("Even if we assume that Congress had intended the term 'use' to have a more limited scope when it passed the original version of [section] 924(c) in 1968 . . . we believe it clear from the face of the statute that the Congress that amended [section] 924(c) in 1986 did not.").

disagreed on what that intent was because it is possible to draw various inferences from the language, depending upon whether one asks about the outer bounds of the language or the most likely intended meaning. Thus, even those who claim to rely on a statute's language and to reject legislative intent recognize that they actually rely on language in order to *ascertain* intent.

Smith also illustrates how little difference there is between the textualists and those who purport to concern themselves more with context. Since his appointment to the Supreme Court in 1986, Justice Scalia's "new textualism"[22] has been seen as a challenge to an intent-oriented approach to statutory interpretation. Yet consider Justice Scalia's rationale for using the "ordinary meaning rule," which is a prominent part of his jurisprudence:

> The question, at bottom, is one of statutory intent, and we accordingly "begin with the language employed by Congress and the assumption that the ordinary meaning of that language accurately expresses the legislative purpose."[23]

Scalia's reasoning is probabilistic: It is a fair bet that Congress, in enacting statutes, would typically have in mind the prototypical meanings of the words it uses. By adopting this assumption, one can concern oneself with the intent of the legislature without ever looking outside the language of the statute.

The courts frequently take ordinary meaning into account, often as a surrogate for legislative intent.[24] For example, *Small v. United States*,[25] decided by the Supreme Court in 2005, construed a law that makes it "unlawful for any person . . . who has been *convicted in any court,* of a crime punishable by imprisonment for a term exceeding one year . . . to . . . possess . . . any firearm."[26] Gary Small had served a prison term in Japan after having been convicted there of weapons charges. The question was whether the statute bars those who have been convicted in foreign courts from owning firearms or whether "in

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[22] The expression "new textualism" comes from Professor Eskridge. *See* William N. Eskridge, Jr., *The New Textualism,* 37 UCLA L. REV. 621, 623 (1990).

[23] Morales v. Trans World Airlines, Inc., 504 U.S. 374, 383 (1992) (quoting FMC Corp. v. Holliday, 498 U.S. 52, 57 (1990) (quoting Park N Fly, Inc. v. Dollar Park & Fly, Inc., 469 U.S. 189, 194 (1985))).

[24] For general discussion of this phenomenon, *see* Lawrence M. Solan, *The New Textualists' New Text*, 38 LOY. L.A. L. REV. 2027 (2005).

[25] 544 U.S. 385 (2005).

[26] 18 U.S.C. § 922(g)(1) (2005) (emphasis added).

any court" should be understood to refer to federal and state domestic courts. The Court relied on ordinary usage to limit the statute's scope to those who have been convicted in American courts: "We should apply an ordinary assumption about the reach of domestically oriented statutes here — an assumption that helps us determine Congress' intent where Congress likely did not consider the matter and where other indicia of intent are in approximate balance."[27]

Textualists and intentionalists alike also make use of arguments based upon coherence to interpret statutes. Justice Scalia opines:

> The meaning of terms on the statute books ought to be determined, not on the basis of which meaning can be shown to have been understood by a larger handful of the Members of Congress; but rather on the basis of which meaning is (1) most in accord with context and ordinary usage, and thus most likely to have been understood by the *whole* Congress which voted on the words of the statute (not to mention the citizens subject to it), and (2) most compatible with the surrounding body of law into which the provision must be integrated — a compatibility which, by a benign fiction, we assume Congress always has in mind. I would not permit any of the historical and legislative material discussed by the Court, or all of it combined, to lead me to a result different from the one that these factors suggest.[28]

We assume, by a "benign fiction," that Congress intends to create a code that makes some sense when the different pieces are fitted together. Other noncontroversial tools of statutory interpretation include the stare decisis effect of earlier court decisions interpreting the statute and various additional canons of construction.

There is one significant aspect of textualism, though, which differs from the approach of those judges who more comfortably acknowledge relying on legislative intent. Textualists eschew legislative history as evidence of intent. In his book, *A Matter of Interpretation,* Justice Scalia explains: "My view that the objective indication of the words, rather than the intent of the legislature, is what constitutes the law leads me, of course, to the conclusion that legislative history should not be used as an authoritative indication of

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[27] 544 U.S. at 390.

[28] Green v. Bock Laundry Mach. Co., 490 U.S. 504, 528 (1989) (Scalia, J., concurring).

a statute's meaning."[29] He continues:

> As I have said, I object to the use of legislative history on principle, since I reject intent of the legislature as the proper criterion of the law. What is most exasperating about the use of legislative history, however, is that it does not even make sense for those who *accept* legislative intent as the criterion. It is much more likely to produce a false or contrived legislative intent than a genuine one. The first and most obvious reason for this is that, with respect to 99.99 percent of the issues of construction reaching the courts, there *is* no legislative intent, so that any clues provided by the legislative history are bound to be false.[30]

Textualists have a particular aversion to legislative history as evidence of legislative intent both because it is unreliable and because it aggrandizes the role of congressional committees and floor managers in a way that usurps the legislative process called for in Article 1, Section 7 of the Constitution.[31]

Yet it is only when legislative history would be dispositive of a case that the different philosophies would yield different results, and such cases are few and far between. Consider, for example, *United States v. Correll*,[32] a 1967 case discussed by Cunningham and Repetti as an example of pre-textualist legal reasoning.[33] At issue in *Correll* was the scope of section 162(a)(2) of the Code, which allows deductions for traveling expenses including "meals and lodging" incurred while "traveling . . . away from home in the pursuit of a trade or business." The taxpayer in that case was a traveling salesman who ate breakfast and lunch on the road, and returned home for dinner each night. The Service had limited the deduction to the person

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[29] ANTONIN SCALIA, A MATTER OF INTERPRETATION 29–30 (Amy Gutmann ed., 1997).

[30] *Id.* at 31–32.

[31] For exposition of this issue, see John F. Manning, *Textualism as a Nondelegation Doctrine*, 97 COLUM. L. REV. 673 (1997). For arguments to the contrary, see Jonathan R. Siegel, *The Use of Legislative History in a System of Separated Powers*, 53 VAND. L. REV. 1457, 1458 (2000). See also Professor Manning's response, John F. Manning, *Putting Legislative History to a Vote: A Response to Professor Siegel*, 53 VAND. L. REV. 1529 (2000), and Professor Siegel's reply to Professor Manning's response, Jonathan R. Siegel, *Timing and Delegation: A Reply*, 53 VAND L. REV. 1543 (2000).

[32] 389 U.S. 299 (1967).

[33] Cunningham & Repetti, *supra* note 3, at 12–13.

whose trip requires him stop for sleep or rest, known as "the overnight rule."

In affirming the overnight rule, the Court relied upon what it inferred to be the intent of the legislature, based upon a number of factors. First, the language of the statute itself suggests this limitation. The conjunction "meals and lodging" suggests that these expenses were intended to be a unit, and such a unit applies only when the taxpayer stays away from home overnight. Second, at the time Congress enacted section 162(a)(2), the Service had already taken this position through a regulation then in place. The Court thus relied on the canon of interpretation which holds: "Treasury regulations and interpretations long continued without substantial change, applying to unamended or substantially reenacted statutes, are deemed to have received congressional approval and have the effect of law."[34] Third, the Court found it appropriate to defer to the Commissioner since Congress had delegated rulemaking authority to the Service, not the courts. Fourth, the Court recognized the overnight rule as reasonably fair. In some sense, everyone who leaves his or her house has "traveled away from home." There is, however, no conceivable reason why the person who works near his or her abode should be able to deduct breakfast at the local diner while the person who works at home should not. Similarly, why should the person who commutes from New York to Washington in a single day be permitted to deduct a fancy lunch at the expense of the taxpayers? Finally, the Court relied, in a footnote, upon the legislative history of several bills that were intended to repeal the overnight rule, demonstrating that Congress was aware of this rule and failed to change it.[35]

We believe that were this case decided today, nothing very different would happen. Most of the arguments put forward by the Court — the coherence of the rule; its support in the statutory language; a canon of construction taking into account a regulation in place prior to legislative enactment; and deference to the Service — would be accepted by most judges. In contrast, reliance on the legislative history of unenacted bills is considered a weak argument at best, and would probably carry little weight, even with those justices willing to consider it at all.[36]

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[34] 389 U.S. at 305–06 (quoting Helvering v. Winmill, 305 U.S. 79, 83 (1938)).

[35] *Id.* at 306 n.20.

[36] Courts do, at times, take into account the failure of legislative efforts to abrogate rules then in place. *See* Bob Jones Univ. v. United States, 461 U.S. 574 (1983) (disallowing charitable status for educational institution with policy of racial segregation); Flood v. Kuhn, 407 U.S. 258 (1972) (exempting baseball's reserve

Correll, however, differs from tax shelter cases in a crucial sense. Mr. Correll did not carefully organize his life to come within the letter of the statute granting the deduction. Rather, he made conventional arguments concerning the interpretation of the Code, and the Supreme Court responded with conventional statutory analysis. Things change when tax attorneys create transactions that take into account ex ante the tools available to a court and navigate through them. As noted earlier,[37] they might create transactions about which the Code is silent or ambiguous and hope for a favorable ruling.

Given this dynamic, courts are likely to have a difficult time disallowing a tax shelter whether or not they rely on legislative history. While courts rely upon legislative intent in making their decisions, they do not rely upon unexpressed legislative intent. The tax planner who is able to take advantage of gaps in the Code and regulations, or who is able to make fair notice arguments whether dealing with a gap or an ambiguity, has a good chance of succeeding.

This is not to say that we endorse the textualist approach to statutory interpretation in tax cases. We do not. For one thing, as Professor Livingston has pointed out, committee reports are especially important in the enactment of tax legislation.[38] Most members of Congress could not possibly read and analyze the texts of the bills. Instead, they rely heavily on the descriptions of them by the relevant committees. For another, judicially-developed doctrines, such as economic substance[39] and business purpose,[40] may never have been developed at all if courts had not been willing to elevate substance over form.[41] These are important tools in enforcing the intended scope of the tax laws.

Significantly, the Service's strongest tool, deference to the Commissioner, will often not be available to the courts for reasons that Hickman describes. Under the *Chevron* doctrine, not yet in place when *Correll* was decided, courts are required to defer to the reasonable interpretation of the administrative agency to which the

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system from antitrust laws).

[37] *See infra* Part I.

[38] Livingston, *supra* note 4, at 836–37.

[39] For a useful discussion of the economic substance doctrine and its evolution, see Joseph Bankman, *The Economic Substance Doctrine*, 74 S. CAL. L. REV. 5 (2000).

[40] The business purpose doctrine can be traced to the Supreme Court's *Gregory v. Helvering* decision. 293 U.S. 465 (1935) (finding the absence of a nontax avoidance motive fatal to the taxpayer's claimed tax treatment).

[41] Cunningham & Repetti, *supra* note 3, at 25–26, make this point.

legislature has delegated the task of enforcement.[42] Both legislative silence and ambiguity may be remedied by administrative action that reasonably comes within statutory authority: "If the statute is silent or ambiguous with respect to the specific issue, the question for the court is whether the agency's answer is based on a permissible construction of the statute. . . ."[43] What this means is that when the Service issues a regulation that is entitled to deference, courts will curtail inquiry into legislative intent as long as the Service's interpretation is a "permissible" construction of the Code. In an earlier article, Hickman argues that any equivocation about the applicability of this doctrine to taxation should be resolved in favor of deference.[44] Of course, tax planners can stay ahead of the curve by creating transactions about which regulations have not been issued. The *Chevron* doctrine, however, surely adds to the government's arsenal.

The problem, Hickman points out, is that deference is most obviously justified when the agency acts through its rulemaking authority, using notice and comment procedures;[45] but the Service most often does not use notice and comment rulemaking. Official Service guidance often comes in the form of either a Notice or a Revenue Ruling. A Notice might offer a preview of forthcoming regulations intended to address an issue[46] or simply announce that certain transactions will be subject to close scrutiny.[47] Revenue Rulings frequently provide the Service's formal view of a given transaction structure.[48] While there is some debate about the type of administrative action to which courts should defer, it would be difficult to justify deference to the Commissioner's position when that position is articulated for the first time in the context of litigation over a tax shelter on which the government had taken no position before its consummation. Thus, the *Chevron* doctrine is not likely to lead to

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[42] Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc., 467 U.S. 837 (1984).

[43] *Id.* at 843 (alteration in original) (footnote omitted).

[44] Kristin E. Hickman, *The Need for* Mead*: Rejecting Tax Exceptionalism in Judicial Deference*, 90 MINN. L. REV. 1537 (2006).

[45] The Supreme Court has wrestled with the question of what kinds of agency action should receive deference. *See* United States v. Mead Corp., 533 U.S. 218, 234–35 (2001).

[46] *See, e.g.*, I.R.S. Notice 95-14, 1995-14 I.R.B. 7 (announcing possible changes to entity classification regulations).

[47] *See, e.g.*, I.R.S. Notice 94-47, 1994-1 C.B. 357 (announcing increased scrutiny of purported debt with equity characteristics).

[48] *See, e.g.*, Rev. Rul. 2003-31, 2003-1 C.B. 643 (providing guidance with respect to "contingent convertible" debt).

the effective regulation of tax shelters other than to outlaw shelters prospectively after a number of taxpayers have profited handsomely. At that point, it remains up to the tax attorneys to find new devices for their clients that will work for a short period of time.

III. LENITY AS A PRINCIPLE IN THE INTERPRETATION OF THE TAX CODE

If the Commissioner is not able to regulate tax shelters out of existence, then the courts must get involved. Hickman's fear is that once they do, they will be tempted to construe the Code narrowly, in keeping with the principle of lenity. If this were to happen, the Commissioner would remain powerless to control the interpretation of the kinds of ambiguities and gaps that become the arbitrage of tax planners who create shelters. In fact, any ambiguity would be mechanically resolved in favor of the taxpayer, making it even more difficult to convince a court to disallow a tax shelter that the legislature would not have intended to permit.

Hickman's fear is not ill-founded. Although lenity is a doctrine traditionally reserved for the interpretation of criminal statutes,[49] the Supreme Court has on several occasions applied lenity in civil cases where the statute in question had both civil and criminal remedies. The notion is that the Court will insist on a single interpretation of the statute, and because there are possible criminal penalties, it is better to interpret the statute narrowly in both criminal and civil contexts.[50]

In one such instance, the statute in question was a tax law, which carried its own criminal consequences. The statute defined "firearm" as including short-barreled rifles, but not long-barreled rifles,[51] and imposed a tax on guns defined as "firearms" under the statute. In *United States v. Thompson/Center Arms Co.*,[52] the Supreme Court decided that a kit that contained a pistol that could be converted to either a long- or short-barreled rifle did not come within the statute and thus was not subject to taxation. Although the case arose in a civil context, the Court noted that failure to register a firearm could

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[49] United States v. Fisher, 6 U.S. (2 Cranch) 358; 389 (1805).

[50] For discussion of the propensity of courts to interpret dual remedy statutes in a unified manner, see Margaret V. Sachs, *Harmonizing Civil and Criminal Enforcement of Federal Regulatory Statutes: The Case of The Securities Exchange Act of 1934*, 2001 U. ILL. L. REV. 1025, 1029 (2001); Lawrence M. Solan, *Statutory Inflation and Institutional Choice*, 44 WM. & MARY L. REV. 2209 (2003).

[51] I.R.C. § 5801.

[52] 504 U.S. 505 (1992).

be criminally prosecuted under the statute, and therefore felt it appropriate to use lenity to resolve the ambiguity in favor of the taxpayer.[53] Since then, the Court has occasionally applied the rule of lenity in civil cases, especially those involving statutes that have both civil and criminal remedies.[54]

We agree with Hickman that expanding the application of lenity to the Code more generally would be a bad result, but do not think it very likely for several reasons. First, notwithstanding these cases, since the early nineteenth century, lenity as a doctrine has been applied to criminal statutes, not to civil statutes. Chief Justice John Marshall articulated the principle of lenity in *United States v. Fisher*,[55] decided in 1805. *Fisher* involved the interpretation of a statute giving priority to the United States over other creditors. Marshall held, "where great inconvenience will result from a particular construction, that construction is to be avoided, unless the meaning of the legislature be plain; in which case it must be obeyed."[56] He later explained in the same decision that the domain of lenity is limited to the criminal context:

> Where rights are infringed, where fundamental principles are overthrown, where the general system of the laws is departed from, the legislative intention must be expressed with irresistible clearness to induce a court of justice to suppose a design to effect such objects. But where only a political regulation is made, which is inconvenient, if the intention of the legislature be expressed in terms which are sufficiently intelligible to leave no doubt in the mind when the words are taken in their ordinary sense, it would be going a great way to say that a constrained interpretation must be put upon them, to avoid an inconvenience which ought to have been contemplated in the legislature when the act was passed, and which, in their opinion, was probably overbalanced by the particular advantages it was calculated to produce.[57]

Thus, the basic rule of statutory interpretation is enforcing the intention of the legislature, and lenity comes into play only when a

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[53] *Id.* at 517–18.

[54] Clark v. Martinez, 543 U.S. 371, 380–81 (2005); Leocal v. Ashcroft, 543 U.S. 1, 11 (2004).

[55] 6 U.S. (2 Cranch) 358 (1805).

[56] *Id.* at 385.

[57] *Id.* at 389.

statute overthrows what were then seen as natural rights or fundamental principles.

Second, many statutes have both criminal and civil remedies. Among them are the antitrust laws, securities laws, the Copyright Act, and various environmental laws.[58] Only rarely does the Supreme Court use lenity as the basis of a decision in a civil case, however. Much of the time, especially when there is both an administrative agency empowered to engage in civil enforcement and a Department of Justice bureau to which criminal cases are referred, enforcement actually becomes more aggressive over time. For example in *United States v. O'Hagan*,[59] the Court interpreted the securities laws broadly in a criminal case despite the fact that the issue had been unsettled in both civil and criminal contexts. It does not appear that the application of lenity in civil cases is becoming the norm.

Third, as Hickman notes, tax fraud has a strong mens rea element. In *Cheek v. United States*,[60] the Supreme Court held that criminal liability for violating the Code requires proof that the taxpayer knew the law and thwarted it. This reduces the pressure on courts to apply lenity across the board. There is no serious likelihood that a broad interpretation of the Code in a civil case will lead to ever-increasing criminal liability, because only those who know their obligations can be successfully prosecuted. We see no evidence that the Court will revoke the *Cheek* doctrine.

The absence of a mechanical rule of lenity in tax shelter cases does not mean, however, that the government will have an easy time of it. Tax law has its own rule akin to the rule of lenity: "Setting the tone for our statutory analysis is the principle that statutes imposing a tax are construed liberally in favor of the taxpayer."[61] Courts are notoriously inconsistent in applying this doctrine, just as they are inconsistent in applying the rule of lenity.[62] One problem that arises is

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[58] *See* 15 U.S.C. §§ 1–7 (2000) (criminal antitrust provisions); 15 U.S.C. § 15 (civil antitrust provision), 15 U.S.C. §§ 77e, 77q (criminal and civil securities provisions), 15 U.S.C. § 78ff(a) (criminal securities provisions); Copyright Act: 17 U.S.C. § 504 (2000) (criminal and civil provisions); Environmental (Clean Water Act): 33 U.S.C. § 1319(b), (c)(2) (2000) (civil and criminal provisions).

[59] 521 U.S. 642 (1997).

[60] 498 U.S. 192 (1991); *see* I.R.C. § 7201.

[61] Ltd., Inc. v. Commissioner, 286 F.3d 324, 332 (6th Cir. 2002).

[62] *Compare* OfficeMax, Inc. v. United States, 428 F.3d 583, 594 (6th Cir. 2005) (invoking the "traditional canon that construes revenue-raising laws against their drafter" in upholding a pro-taxpayer district court outcome) (citation omitted), *and* Mut. of Omaha Ins. Co. v. United States, 317 F. Supp. 2d 1117, 1123 (D. Neb. 2004)

the determination of when in the interpretive process the principle applies. Should courts resort to favoring the taxpayer relatively early in the process, it will be harder for the government to prevail. If, in contrast, courts do not apply this principle unless they have determined that the statute is ambiguous and fail to glean legislative intent from other inquiry, then the rule will be applied less frequently. Typically, the rule is applied — if at all — in this narrower set of circumstances.

For example, section 4471 of the Code imposes a $3.00 tax per cruise ship passenger, imposed "either at the time of first embarkation or disembarkation in the United States."[63] The question in *Royal Caribbean Cruises, Ltd. v. United States*,[64] was whether the tax applies when the ship begins and ends its voyage outside of the United States, but makes stops in United States ports as part of the voyage. After looking at various regulations, instances of trade usage, and a few dictionaries, the court found that the terms "embarkation" and disembarkation" are ambiguous. The terms could mean the beginning and end of a voyage, or getting on and off the ship at any time. Consequently, with no strong evidence to resolve the ambiguity, the court gave the taxpayer the benefit of the doubt.

At the same time, courts sometimes refuse to construe the Code in favor of the taxpayer when they conclude that they have enough information to infer congressional intent to impose a tax. For example, in *F.E. Schumacher Company, Inc. v. United States*,[65] the taxpayer had filed its payroll taxes in the correct amount and within the statutory time frame, but had not used the Electronic Federal Tax Payment System (EFTPS), as required under the relevant Treasury Regulation.[66] Section 6656 calls for penalties to be assessed for failure to deposit payroll taxes as follows:

(interpreting the phrase "redemption at maturity" in accordance with the rule of statutory construction that "federal tax legislation that is intended to provide relief is to be liberally construed in favor of the taxpayer" to find that one category of instruments satisfied the statutory requirement even though another did not), *with* Spicer Accounting, Inc. v. United States, 918 F.2d 90, 95 (9th Cir. 1990) (concluding that the taxpayer "failed to satisfy" the relevant statutory requirement, "however liberally construed"), *and* Freightliner of Grand Rapids, Inc. v. United States, 351 F. Supp. 2d 718, 723 (W.D. Mich. 2004) (concluding that the taxpayer's argument failed even if the regulation in question was "construed liberally in favor of the taxpayer.").

[63] I.R.C. § 4471(c).

[64] 1995 U.S. Dist. LEXIS 8243 (S.D. Fla. May 31, 1995).

[65] 308 F. Supp. 2d 819 (N.D. Ohio 2004).

[66] Treas. Reg. § 31.6302-1(h) (as amended in 2006).

> (a) Underpayment of deposits.— In the case of any failure by any person to deposit (as required by this title or by regulations of the Secretary under this title) on the date prescribed therefore any amount of tax imposed by this title in such government depository as is authorized under section 6302(c) to receive such deposit, unless it is shown that such failure is due to reasonable cause and not due to willful neglect, there shall be imposed upon such person a penalty equal to the applicable percentage of the amount of the underpayment.[67]

The taxpayer claimed that the penalty did not apply since it had deposited the required funds in a timely manner. The Service argued that by not doing so "as required by this title or by regulations of the Secretary under this title" it came within the penalty provisions.

Relying on the plain language of the statute, the structure of the statute, and a Revenue Ruling, which the court found helpful though not dispositive, the court held for the government. As for the rule that tax laws are to be construed in favor of the taxpayer, the court made the following comment:

> Although these principles inform Tax Code interpretation, they do not authorize fragmentary exploitation of any one section in the interest of avoiding compliance with the Code or tax liability reduction. The Court is without doubt in this case. A cohesive construction of the relevant Internal Revenue Code sections permits only one conclusion: Section 6656 authorizes penalties for Plaintiff's failure to deposit its employment taxes electronically under the EFTPS.[68]

The court further inferred that Congress had intended the penalties to apply when the taxpayer failed to comply with the procedures set forth in the regulations.[69]

Applying the principle that ambiguities in tax laws should be construed narrowly mirrors a parallel approach in the application of the rule of lenity. In 1961, Justice Frankfurter noted the following in an opinion:

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[67] I.R C. § 6656(a).

[68] *F.E. Schumacher*, 308 F. Supp. 2d at 828.

[69] *Id.* at 827.

> But that "rule," [i.e., the rule of lenity] as is true of any guide to statutory construction, only serves as an aid for resolving an ambiguity; it is not to be used to beget one. "To rest upon a formula is a slumber that, prolonged, means death." The rule comes into operation at the end of the process of construing what Congress has expressed, not at the beginning as an overriding consideration of being lenient to wrongdoers. That is not the function of the judiciary.[70]

Thus, whether we speak of criminal statutes or tax statutes, a court is most likely to default to a narrow interpretation only after it has done its best to divine the intent of the legislature. Judges differ as to where to look for such intent, and for that matter, how to interpret the evidence they find. For that reason, results remain uncertain in close cases.

IV. LENITY, INTENT, AND THE STATUS OF TAX SHELTER LITIGATION

Now let us return to the KPMG tax shelters that Hickman discusses. The shelters that are the focus of Hickman's analysis might appear to bear no resemblance to our doctor and the orange grove discussed at the beginning of this essay,[71] but in certain respects they are quite similar. Like that shelter, they arguably complied with the literal language of the relevant statutory and regulatory provisions, but produced tax results that Congress likely did not intend. Each shelter was designed to survive a legal challenge,[72] taking into account all of the enforcement tools available to tax authorities. They were also susceptible to prospective intervention,[73] which was not long in

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[70] Callanan v. United States, 364 U.S. 587, 596 (1961) (alteration in original) (citation omitted) (footnote omitted).

[71] *See supra* note 4 and accompanying text.

[72] Of course, some shelters do not survive challenges by tax authorities no matter how clever their legal arguments. As described below, in the particular instance Hickman discusses, a BLIPS shelter survived a challenge to its pro-taxpayer interpretation of an ambiguous statute. Klamath Strategic Inv. Fund, LLC v. United States, 440 F. Supp. 2d 608, 624 (E.D. Tex. 2006). Nevertheless, the same court later determined that the complex transactions intended to implement the shelter "lacked economic substance" and that the shelter was therefore invalid. Klamath Strategic Inv. Fund, LLC v. United States, 2007 U.S. Dist. LEXIS 6939, 58 (E.D. Tex. 2007).

[73] Regulations intended to extend retroactively to apply to the BLIPS transaction at issue were declared invalid to the extent they attempted to apply beyond the date on which the initial IRS Notice disapproving of such transactions was

coming after these shelters came to light.

The first shelter, BLIPS, achieves its desired tax result by substituting a "premium" for a "liability."[74] The relevant statute, section 752, describes the effect of debt, labeled "liabilities" by the statute, on the tax treatment of transactions involving partners and partnerships. In drafting section 752, Congress anticipated the existence of prototypical liabilities, such as debt, in these transactions. One outcome it specifies is that the assumption of any such liability of a partner by a partnership will reduce the partner's basis, effectively reducing any future losses produced by a disposition of the partner's partnership interest. However, neither Congress nor the Treasury Department appears to have anticipated the use of a premium to achieve an economically indistinguishable result.[75] As a result, although there is no economic justification for treating the premium more favorably, the BLIPS shelter exploited a statutory vulnerability to avoid the basis/loss reduction that the use of a conventional liability would have generated.[76] Those preserved losses could be used to shelter other income from taxation.

The second shelter, FLIP or OPIS,[77] takes advantage of rules distinguishing between redemptions and dividends. Those rules were designed to make redemption status relatively difficult to achieve so that most transactions that could reasonably be characterized as either dividends or redemptions would be treated as dividends unless they fall within narrow safe harbors. That approach reflects the government's myopic[78] belief that taxpayers can be expected to seek

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published. Klamath, 440 F. Supp. 2d at 624.

[74] Hickman, *supra* note 1, at 927.

[75] *See* Hickman, *supra* note 1, at 927 n.100 and accompanying text. In fact, tax authorities had long focused on precisely the opposite risk: that taxpayers would aggressively seek to treat non-prototypical liabilities as "liabilities" for section 752 purposes. *See* Klamath, 440 F. Supp. 2d at 615–17 (describing the Service's long-time litigation strategy of narrowly construing "liabilities" for section 752 purposes).

[76] The report on the tax shelter industry published in connection with the recent tax shelter hearings provides a helpful description of the BLIPS transaction. *See U.S. Tax Shelter Industry: The Role of Accountants, Lawyers, and Financial Professionals Before the Permanent Subcommittee on Investigations of the Senate Committee on Governmental Affairs,* 108th Congress, Appendix A (2003) (report prepared by the Minority Staff of the Permanent Subcommittee on Investigations titled, "U.S. Tax Shelter Industry: The Role of Accountants, Lawyers, and Financial Professionals, Four KPMG Case Studies: FLIP, OPIS, BLIPS, AND SC2").

[77] Hickman, *supra* note 1, at 929.

[78] Eustice refers to this bias in favor of dividend treatment as a classic example of "IRS Myopia" that allows taxpayers to achieve favorable results by using tax rules

redemption treatment. By intentionally failing to qualify[79] for the "complete redemption" safe harbor of section 302(b)(3), the transaction achieves the default (i.e. dividend) treatment. In a prototypical case, that dividend treatment would be undesirable, but in this instance it allows a tax indifferent (foreign) party to shift tax benefits to a U.S. taxpayer.[80]

A prescient Congress could, and perhaps would, have expressly denied purchasers of BLIPS, FLIPS, and OPIS shelters the benefits they sought. Certainly, with the benefit of hindsight, each of those transactions, like the passive loss-generating investments of doctors and lawyers decades ago,[81] has been the subject of prospective intervention. A new regulatory provision sufficed to remedy the "premium" ambiguity[82] exploited by the BLIPS shelter.[83] An IRS Notice[84] and, ultimately withdrawn, proposed regulations[85] rejected the analysis underlying the FLIP and OPIS shelter, thereby closing a gap[86] in the existing statutory and regulatory framework.

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intended to be pro-government in non-prototypical contexts. James S. Eustice, *Abusive Corporate Tax Shelters: Old "Brine" in New Bottles*, 55 TAX L. REV 135, 143 (2002). A belief that was always myopic is now also somewhat dated as taxpayers may apply the lower capital gains rates once only available to redemptions to dividends. I.R.C. § 1(h)(11).

[79] The safe harbor failed to apply because the redeeming shareholders retained a "constructive" interest in the corporation through an option. Hickman, *supra* note 1, at 930.

[80] Hickman, *supra* note 1, at 931.

[81] *See supra* note 6 and accompanying text.

[82] The use of the term "liability" gives rise to ambiguity in that it could either be interpreted narrowly to include only instruments labeled "debt" or could include any obligation with a negative economic value. Alternatively, the failure of the statute to address whether liabilities should be interpreted to include something that is not formally debt but has the same economic characteristics as a liability could be thought of as a "gap" in the statute.

[83] Treas. Reg. § 1.752-1(a)(4)(ii) (2005) (defining "obligation" and thus "liability" broadly to include not only "debt obligations" but also non-debt obligations such as "tort obligations" and "contract obligations").

[84] I.R.S. Notice 2001-45, 2001-2 C.B. 129.

[85] *See* Hickman, *supra* note 1, at 927 nn.100–01 and accompanying text.

[86] One could also fairly characterize the problem of whether the foreign shareholder giving up shares in the FLIP/OPIS shelter in fact was redeeming shares or receiving a dividend as a problem of ambiguity. Specifically, even if the safe harbor is inapplicable, the decidedly ambiguous section 302(b)(1) "not essentially equivalent to a dividend" standard might or might not apply to treat the transaction as a redemption.

There is no real question as to whether Congress would have acted differently had the substitution of premium for liability been commonplace, or had it been able to anticipate the cross-border exploitation of the dividend/redemption distinction. The shelters were designed to capitalize on the difficulty of divining, or at least of conclusively demonstrating, that Congress intended a result other than the one KPMG claimed the shelters produced. Had section 752 included the definition of liability now contained in the regulations,[87] a court would have had little difficulty seeing that the losses produced by the BLIPS shelter were inconsistent with Congress' intent.

Of course, an adequately far-sighted Congress could also have easily eliminated the ambiguity produced by the phrase "use a firearm" at issue in the *Smith* case[88] or specified that only persons convicted in U.S. federal, state, or local courts would be barred from owning firearms, thereby eliminating the issue litigated in *Small*.[89] What makes tax shelters different is that had such language existed, skilled tax planners would have replaced BLIPS with some other transaction structure that even a paranoid Congress would be hard-pressed to imagine. As the FLIP/OPIS shelter demonstrates, even in their most cautious moments tax authorities are not particularly good at creating rules that are not prone to exploitation by some future taxpayer.[90]

Even if the encroachment of lenity that Hickman fears were not to materialize, and even if textualism were to fall out of favor, tax shelters like those described above would continue to bedevil tax authorities. Exacerbating the difficulty they face when taxpayers are able to choose the statutory battlefield is the fact that taxpayers' characterization of a statutory indeterminacy can prove decisive. To the extent that a taxpayer employing a shelter manages to persuade a court that it has exploited a statutory gap, rather than an ambiguity, tax authorities will find it difficult to prevail. For example, the FLIP/OPIS shelter is a product of the government's focus on taxpayers seeking redemption treatment.[91] The highly detailed system of presumptions and safe harbors exploited in producing the shelter were not ambiguous so much as inadequate.[92] A court could easily

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[87] *See supra* note 83.

[88] *See supra* text accompanying note 20.

[89] *See supra* text accompanying note 25.

[90] That shelter took root in the context of overzealous, rather than lax, rulemaking. *See supra* note 77 and accompanying text.

[91] *See supra* note 77 and accompanying text.

[92] The constructive ownership rules Hickman describes are not susceptible to

extrapolate from the existing rules to fill the gap left by Congress and the Treasury Department in order to invalidate the shelter. However, courts are even less inclined to fill such gaps than they are to resolve ambiguities against taxpayers.

The BLIPS shelter, by contrast, exploits a statutory weakness that, like the use of the undefined term "farmer" in the hypothetical statute discussed in Part I, can fairly be thought of as either an ambiguity or a gap. The term is ambiguous if "liability" is viewed as having two different meanings. On the one hand, "liability" may be understood as referring only to debt instruments, in effect sanctioning the taxpayer's claimed tax treatment. On the other hand, it may be interpreted as referring to debt instruments and any economically equivalent obligations.[93] The result is ambiguity.

However, one may take an entirely different view. One may conclude that the language of the statute is unambiguous, but under-inclusive, addressing only transactions involving a conventional debt instrument. Taking that view, a court would be reluctant to expand the scope of the statute to apply to the BLIPS transaction. Even a non-textualist court open to the idea of relying on legislative history and other contextual information to interpret a statute would be unlikely to do so if it finds the statutory language to be clear. At the same time, the lack of ambiguity would obviate the application of lenity and similar principles.

Two controversial recent decisions illustrate the challenge the government faces in defeating cleverly designed tax shelters even when facing non-textualist judges willing to employ a broad range of contextual evidence, including legislative history, to resolve statutory ambiguities. Because the difference between a statutory gap and an ambiguity tends to be slight and the consequences of classification can be dramatically different (if an ambiguity is misclassified as a gap, even non-textualists will reject all contextual evidence), success can ride largely on persuading a court that a statutory flaw is an ambiguity.

Gitlitz v. Commissioner[94] exemplifies the significance of the classification of a statutory flaw. Justice Breyer, the lone dissenter, determined that ambiguity existed that justified recourse to legislative

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two different meanings; they simply produce favorable tax treatment that Congress almost certainly did not intend to provide. *See* Hickman, *supra* note 1, at nn.94–95.

[93] This broad interpretation is adopted by the current regulations. *See supra* note 83.

[94] 531 U.S. 206 (2000).

history in interpreting the statute.[95] The majority, which ruled in favor of the taxpayer, declined to rely on that legislative history. Although that majority opinion was written by Justice Thomas, a textualist unlikely to ever turn to legislative history to interpret a statute, he was supported by all but one of his fellow justices, including Justice Stevens, who has spoken out against textualist methodology.[96] Moreover, the majority relied both upon legislative purpose,[97] and upon the statute's enactment history.[98] Of the eight justices forming the majority in *Gitlitz*, it would not be unreasonable to conclude that at least one declined to rely on the legislative history cited by the dissent simply because that justice perceived no ambiguity rather than because of a hostility to legislative history generally.

A second case involving a tax shelter relying on the same principles as the BLIPS shelter clearly shows the impact of the classification of a statutory flaw as a gap rather than an ambiguity. In *Black & Decker Corp. v. United States*,[99] the government argued that the legislative history demonstrated that Congress did not have transactions like the taxpayer's in mind when drafting a provision on which the taxpayer's favorable tax treatment relied.[100] After relying on legislative history to resolve one ambiguity in the statute,[101] the court concluded that although the transaction in question may not have been "[t]he prototypical transaction Congress had in mind in drafting [section] 357(c)(3)" that fact "does not imply . . . that Congress silently contemplated a case [like the taxpayer's] and

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[95] Gitlitz, 531 U.S. at 221 (Breyer, J. dissenting) (noting a House Committee report supporting the Commissioner's position).

[96] *See, e.g.*, Bank One Chicago, N.A. v. Midwest Bank & Trust Co., 516 U.S. 254, 276–77 (1996) (arguing for the relevance of legislative history. For discussion of Justice Stevens' views on this matter, *see* Charles Tiefer, *The Reconceptualization of Legislative History in the Supreme Court*, 2000 WIS. L. REV. 205, 225–30.

[97] Gitlitz, 531 U.S. at 215 n.6 (". . . the very purpose of Subchapter S is to tax at the shareholder level, not the corporate level.").

[98] *Id.* at 220 n.10.

[99] Black & Decker Corp. v. United States, 436 F.3d 431, 436–37 (4th Cir. 2006).

[100] Like the BLIPS transaction, Black & Decker's favorable tax treatment relied on avoiding a basis reduction triggered by a transfer of an economic liability to a newly formed entity. To avoid the basis reduction in this case, the taxpayer needed to ensure that the liability transferred satisfied the requirements of section 357(c)(3), which waived the requirement of a basis reduction when payment of the "liability . . . would have given rise to a deduction." *Id.* at 436; *see also* I.R.C. § 357(c)(3)(A).

[101] The statute failed to specify whether deductibility should be determined at the transferor or transferee level. The court relied on legislative history to resolve this ambiguity in favor of the taxpayer. Black & Decker Corp., 436 F.3d at 436.

concluded that [section] 357(c)(3) should not apply."[102] The court reasoned that nothing in the statute's "plain language embraces such a limitation," and as a result there was "no ambiguity in the statute" that would justify employing legislative history to determine whether this transaction was the type of transaction Congress intended to benefit from section 357(c)(3).[103]

V. CONCLUSION

We have seen that:

1. Tax shelters typically attempt to create tax benefits in situations where the legislature did not intend to provide favorable treatment;

2. Most judges consider the intent of the legislature in interpreting statutes;

3. Judges are not usually willing to infer meaning beyond what at least some reasonable reading of the statutory language would permit;

4. At times, contrary inferences can be drawn from the inquiry into intent; and

5. When courts cannot determine the intent of the legislature, they resolve disputes in favor of the taxpayer as a default.

In these circumstances, we would expect the government to have mixed success in opposing tax shelters. Notwithstanding bouts of pessimism prompted by some failures,[104] the record is mixed indeed. Government victories have both closely followed and been closely followed by losses.[105] Those wins and losses often involve the same

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[102] *Id.* at 437 (internal citations omitted).

[103] *Id.*

[104] *See, e.g.*, Schler, *supra* note 9, at 346–47

[105] *Compare* ACM P'ship v. Commissioner, 73 T.C.M. (CCH) 2189 (1997) (finding government challenge of tax shelter transaction successful) *with* Boca Investerings P'ship v. United States, 167 F. Supp. 2d 298 (D.D.C. 2001) (finding challenge of "ACM clone" transaction unsuccessful). A similar pattern can be observed with respect to the government's efforts to combat corporate owned life insurance (or COLI) transactions. The government won a number of cases involving COLI transactions. *See, e.g.*, Winn-Dixie Stores, Inc. v. Commissioner, 113 T.C. 254 (1999). A taxpayer eventually won a COLI case. Dow Chem. Co. v. United States,

litigation.[106]

It would be difficult to identify a single culprit responsible for the recent wave of tax shelters. Whatever contributing role it may have played, textualism probably does not deserve the lion's share of blame. The inevitable existence of statutory and regulatory gaps in a system of rules as complex as today's tax laws leaves tax authorities at a disadvantage that courts, whether textualist or not, often feel powerless to remedy. Emerging developments such as the increased prominence of the rule of lenity, the trend Hickman has identified, undoubtedly create a risk that courts will be marginally less likely to defer to the Treasury Department and the Service. Even if we are wrong, however, and tax authorities find themselves faced with one more obstacle in their efforts to bring an end to a particularly virulent outbreak of tax shelter activity, that one obstacle is unlikely to turn the tide against them.

Can anything be done to improve the Treasury's ability to collect the taxes that Congress meant to impose? The most straightforward tool — the adoption of an aggressive purposive approach to the interpretation of the tax laws, regardless of the statutory language — is too far outside today's jurisprudence to be a credible option.[107] Yet courts do have the opportunity to be more effective simply by using tools that are readily available to them. For example, the "ordinary meaning" canon,[108] which limits a statute's scope to those situations that come within the ordinary usage[109] of the statutory language, and therefore are more likely to be within the law's intended domain, can well be employed to disallow tax shelters that leverage plausible, but

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250 F. Supp. 2d 748 (E.D. Mich. 2003). However, both of those taxpayer victories were successfully challenged on appeal. Boca Investerings P'ship v. United States, 314 F.3d 625 (D.C. Cir. 2003); Dow Chem. Co. v. United States, 435 F.3d 594 (6th Cir. 2006).

[106] In addition to the appellate victories described in the prior footnote, the government recently enjoyed appellate success in a case involving principles similar to those employed in the BLIPS shelter. *See* Black & Decker Corp. v. United States, 436 F.3d 431 (reversing grant of summary judgment in favor of taxpayer with respect to a "contingent liability" tax shelter similar to the BLIPS transaction).

[107] For a defense of this approach, *see* AHARON BARAK, PURPOSIVE INTERPRETATION IN LAW (Sari Bashi trans., 2005).

[108] *See supra* notes 20, 23–24, 27.

[109] Ordinary usage need not refer to what would be apparent to a non-specialist. It could well be taken to mean ordinary for the highly specialized intended audience of these tax provisions. For discussion of the intended audiences for statutory language, see William S. Blatt, *Interpretive Communities: The Missing Element in Statutory Interpretation*, 95 NW. UNIV. L. REV. 629 (2001).

unusual applications of statutory language. If courts had demonstrated a willingness to employ that canon in this context, the government might have pitched its argument regarding the atypical nature of the transaction underlying Black & Decker's contingent liability shelter differently. Rather than relying on legislative history to divine legislative intent, the issue could have been framed as an ordinary meaning question: was Black & Decker's transfer of bare liabilities outside of the ordinary meaning of the statute because it bore no resemblance to the "prototypical transaction Congress had in mind in drafting" the statute?[110] As we saw above, this interpretive doctrine is embraced by textualists and non-textualists alike.

In some ways, anti-abuse doctrines, whether statutory or judicially-created, are examples of this approach. One way of understanding the business purpose doctrine, for example, is that it permits courts to distinguish between the kinds of transactions that occur in the ordinary course of business from those that are non-prototypical and therefore less likely to come within the intended meaning of a statute. Anti-abuse statutes and regulations draw the same distinctions.[111] These doctrines are very important, because they permit courts to focus on a statute's purpose without looking outside its language. Notwithstanding these tools, we have little doubt that skilled planners will continue to find ways of thwarting legislative intent, at least until Congress or the Treasury acts to put out fires with respect to individual shelters. Yet we also believe that it is very much worthwhile for the courts and the Treasury to be aware of what interpretive tools they have and to use them in the service of enforcing the will of the legislature.

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[110] The court was open to the possibility that Black & Decker's transaction may have borne little resemblance to the "prototypical transaction Congress had in mind in drafting [section] 357(c)(3)" but concluded that without ambiguity in the statute it had no reason to "parse the Congressional record and discern what *type* of business transactions Congress originally envisioned in enacting the section." Black & Decker Corp., 436 F.3d at 437. That "ordinary meaning" argument would have allowed the government to distinguish between the taxpayer's transaction and a typical business transaction without using any evidence of legislative intent other than the words of the statute.

[111] For discussion of the value of these statutes, see Ellen Aprill, *Tax Shelters, Tax Law, and Morality: Codifying Judicial Doctrines*, 54 SMU L. REV. 9 (2001).