

## 222 Years of the Supreme Court, The Constitution, and Federal Tax

By Jasper L. Cummings, Jr.



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Cummings argues that the Supreme Court has played a more useful role in creating income tax law than is generally supposed. The Court has also fostered a very expansive view of the federal power to tax, which will be tested by the pending healthcare tax case, not because the legal attacks are well founded but because, as in the days of *Pollock*, there is a confluence of impassioned advocacy and a receptive Court.

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The Supreme Court is like a tenured professor who still has to teach a survey course, but is mostly interested in the narrow subject matter of his honors seminar. For the Court the honors seminar is the Constitution; that is the subject that the Court owns, about which it might say: "This is Our House." As a result of the Court's long care and feeding, the Constitution now has multiple nuances of meaning that cannot be derived from its text, including in the area of the federal taxing power.<sup>1</sup>

### A. Direct vs. Indirect Taxes

While those nuances have grown in part due to the length of the Constitution's 222 year history, they began from the very start. The 1796 opinion in *Hylton*, the first federal tax constitutional case to be decided by the Court, reached the surprising conclusion that a tax on carriages was not a direct tax and so did not have to be apportioned among the

states based on the census.<sup>2</sup> This seems surprising in hindsight because direct taxes were thought to include at least taxes on property, although the meaning of direct taxes was uncertain. Because the Court ruled it was not a direct tax, the carriage tax was left to fall in the other category of federal taxes authorized by the Constitution: "duties, excises and imposts." The only limitation placed on them is uniformity, which has come to mean that the tax is applied uniformly across the nation to transactions or businesses or property wherever they are found. Of course some things turn up more in one part of the country than another — perhaps carriages more in cities and ships along the seacoast — but that does not make a tax fail the uniformity requirement.

Why is the 1796 carriage tax ruling relevant today? It shows that from the very start the Court has been protective of the federal taxing power. The Court basically gave Congress credit for being able to read the Constitution: if Congress had intended to levy a direct tax on carriages, it would have apportioned it. Not having apportioned the tax, Congress must have intended to impose an excise tax, which was constitutional. It also shows how nuanced the reasoning about federal taxes very quickly became: a \$10 tax on a carriage could be a direct property tax if Congress called it a property tax, but if Congress called it an excise on the use of the carriage it was an excise tax. Thus began in 1796, in a Supreme Court opinion, the practice used by tax lawyers today of relying on distinctions that no one else can see.

### B. *McCulloch v. Maryland*

The most famous state tax case to come before the Court in the early days, *McCulloch v. Maryland*, contained the famous phrase "the power to tax involves the power to destroy."<sup>3</sup> That phrase sometimes is intoned by conservative commentators to warn listeners how dangerous and bad taxation is. That was not Chief Justice Marshall's meaning at all. The opinion struck down the Maryland tax on the Bank of the United States, because Maryland could not be allowed to have a power over the supreme national government and its instrumentalities that was intended to be so unlimited as the power to tax.

<sup>1</sup>This speech is based on a forthcoming book by the author, *The Supreme Court, The Constitution and Federal Taxation*.

<sup>2</sup>*Hylton v. United States*, 3 U.S. 171 (1796).

<sup>3</sup>*McCulloch v. Maryland*, 17 U.S. 316, 431 (1819).

The decision stands for several important principles: (1) the supremacy of the federal government in relation to the states (its most important principle), (2) the immunity of one government from taxation by another government (which led to a century of confusion until intergovernmental tax immunity was reined in in the late 1930s), (3) the unlimited scope of the power to tax, and perhaps less noticed (4) the understanding that taxes can regulate.

As to the last principle, the Court knew that Maryland was not trying to raise money from the Bank of the United States but rather wanted to keep it out of Maryland or at least punish it for operating in Maryland, which is regulation. So it was not so much that Maryland might break the United States Treasury through taxing the Bank; after all the Bank could just avoid Maryland and pay nothing. The point was that Maryland was trying to regulate the United States government, which it could not do because the United States is the supreme government when it acts within its powers, which the Bank was found to be. That taxes can serve the purpose of regulation is embedded deeply in the Constitution, which authorizes Congress to levy tariffs (which are clearly taxes) on imports; tariffs have almost always served the dual if not sole purpose of protecting domestic industries, i.e., regulation.<sup>4</sup>

Why is *McCulloch v. Maryland* relevant today? Because on November 14, 2011, the Court agreed to hear four consolidated appeals from the decision that ruled unconstitutional the tax on individuals who fail to obtain health insurance coverage as will be required under The Patient Protection and Affordable Care Act that was signed into law on March 23, 2010. The Court will once again be evaluating the unlimited power of the United States to tax and will be asked to decide again whether a tax also can regulate, which the Court has known to be a function of taxation since *McCulloch v. Maryland*.

### C. Tax Statutory Construction

But the Court's tax work has not been limited to constitutional issues. It has issued over 900 opinions in total on federal tax interpretation and application, not involving the Constitution.<sup>5</sup> This dual role

for the Court — effectively creating the meaning of the Constitution and also tending to other legal issues — has produced dual effects on the Court's jurisprudence.

On the one hand it creates constitutional law with relative freedom because of its supremacy among the branches of government; on the other hand it decides cases like tax disputes, hemmed in by the code, the regulations, and other constraints generated by the other two branches of government. Outside of its constitutional specialty it operates as the quite skilled, but somewhat distant, professor, who brings his formidable analytics episodically to a variety of subjects that may not be in his area of principal interest. Those usually do not include the same depth of knowledge of the nuances of the legal subject matter that the Court possesses in its constitutional seminar area.

As a result, the Court's forays into code interpretation can seem like lightning bolts illuminating only the immediate area for a second,<sup>6</sup> or sporadic omnipotence,<sup>7</sup> to use criticisms applied by Justices Douglas and Robert Jackson. Tax practitioners agree with these criticisms, which creates a problem for accurate understanding of what the Court does in tax cases.

Federal taxation cases may, or at least used to, come closest to being the exception to the rule that the Court would rather not spend too much time with cases of statutory construction. The reasons include the facts that taxation is so darn important, and so pervasive and the Internal Revenue Code is such a huge and hugely articulated and interpreted law. Indeed, in the first half century of the federal income tax the Court largely created the federal tax law, as it creates the constitutional law.

Taxpayers didn't know what income was in 1913 when the very brief original taxing statute was enacted under the Sixteenth Amendment. The Treasury couldn't quite decide how to compute income as an accounting matter: cash or accrual; and how exactly did the taxable year work? Who answered many of these fundamental questions? The Supreme Court. It created what we call doctrines: assignment of income; constructive receipt; cancellation of indebtedness; taxpayer's burden of proof; holding the taxpayer to the form of its transactions, usually; claim of right; tax benefit rule; and on and on. The Supreme Court's federal tax case load was

<sup>4</sup>For example the first tariff act was explained in its section 1: "Whereas it is necessary for the support of the government, for the discharge of the debts of the United States, and the encouragement and protection of manufactures, that duties be laid on goods, wares and merchandise imported: Be it enacted." The Tariff Act of July 4, 1789.

<sup>5</sup>See generally Jasper L. Cummings, Jr., *The Supreme Court's Federal Tax Jurisprudence* (2010).

<sup>6</sup>Justice Douglas dissenting in *United States v. Skelly Oil Co.*, 394 U.S. 678, 690-691 (1969).

<sup>7</sup>"I still think the Tax Court is a more competent and steady influence toward a systematic body of tax law than our sporadic omnipotence in a field beset with invisible boomerangs," *Arrowsmith v. Commissioner*, 344 U.S. 6 (1952) (dissent of Justice Jackson).

very heavy up to the 1950s, sometimes forming the largest category of decisions in a year. And some of the Court's members who were most famous for other reasons tended to write the important tax decisions: Justices Brandeis, Stone, Cardozo, Black, Jackson and Marshall.

And the Court attacked its federal tax caseload with relish, at least in the earlier days. It did not view the tax collection efforts of the United States as some sort of subversive activity to be hemmed in at every turn. Except for a fourteen year period from 1922-1936 when it ruled several federal taxes unconstitutional on grounds not repeated after 1936,<sup>8</sup> it has bent over backwards to make the federal tax system work. For example, there was an old presumption carried over from the English stamp and customs cases that the tax laws were interpreted against the Crown<sup>9</sup>; the Court followed that for a while, but by the 1930s had abandoned and reversed it.<sup>10</sup> The current approach combines an expansive definition of gross income, which took some work to attain between *Macomber* and *Glen-shaw Glass*, with an offsetting strict construction of exemptions, deductions and other allowances.<sup>11</sup>

But the Court's tax expertise has for several decades been in bad odor in some quarters for several reasons. First, its sporadic forays into federal tax have become downright rare, with the result that almost any ruling it issues is likely to shock, just by virtue of its novelty. Second, at times it has seemed indecisive in tax cases. For example, in 1945 the Court ruled in the *Court Holding Company* decision that a liquidating corporation actually sold property that its shareholders formally sold after they received it in liquidation.<sup>12</sup> Five years later in *Cumberland Public Service* the Court ruled the other way on what seems like identical facts.<sup>13</sup>

This about face, was not, however, an error on the Court's part, but rather is an example of how the Court's opinions are misunderstood. Granted the facts in the two cases are quite similar. Even

Congress took note of how hard it was to tell one situation from the other and was prompted to enact a presumption that made it unnecessary to do so (corporate sale of property within 12 months before liquidation would not be taxed, just as a liquidating distribution was not taxed under the *General Utilities* Doctrine). But the Court made a reasoned distinction between these two cases and created what I call a cluster rule for fact finding in this particular sort of case: the party that negotiates the sale is the seller for tax purposes, when the property is sold immediately after a corporate distribution.<sup>14</sup>

If the Court were given more credit for deciding many cases based on "all the facts and circumstances," as it should be, then practitioners might be more prepared to accept a "rule" of fact finding as appropriately limited to a particular sort of scenario, rather than being a global pronouncement for all places and all times. I will return to this concept of limited cluster rules in connection with the so-called economic substance doctrine.

A second reason why some shudder when the Court takes up a federal tax cases is that it has made some questionable rulings that haunted the tax law for decades, even half a century. For example the Court's *General Utilities* Doctrine reigned for over 50 years, causing the need for numerous amendments to section 311 and the creation of section 338 and its predecessors, all because the government did not timely argue that the corporation effectively recognized the gain in the distributed assets (or was the real seller, as in *Court Holding*).<sup>15</sup> Perhaps the Court can't be faulted for the government's litigating error; and perhaps the government should be faulted for not trying again. Similarly long lived was the ultimately impossible task of trying to discern corporateness of entities based on the Court's *Morrissey* opinion,<sup>16</sup> which led to the check the box regulations.

And sometimes the Court gets too far ahead of its proper role of deciding the case before it, and tries in addition to create a template for future cases, only to have to backtrack, as happened with *National Carbide* and its six factors for how to tell if a corporation is an agent of the shareholders,<sup>17</sup> which *Bollinger* had to modify. Justice Scalia made the remarkably honest statement in the *Bollinger* opinion: "In any case, we decline to parse the text of *National Carbide* as though that were itself the

<sup>8</sup>When it decided *J.W. Bailey v. Drexel Furn. Co.*, 259 U.S. 20 (1922) (aka Child Labor Tax Case); *Hill v. Wallace*, 259 U.S. 44 (1922); *Trusler v. Crooks*, 269 U.S. 475 (1926); *United States v. Constantine*, 296 U.S. 287 (1935); *United States v. Butler*, 297 U.S. 1 (1936); *Carter v. Carter Coal Co.*, 298 U.S. 238 (1936). These were the decisions that said a tax was not a tax. Three other rulings in this period held federal estate tax rules unconstitutional on grounds or alleged retroactivity.

<sup>9</sup>*United States v. Isham*, 84 U.S. 496 (1873); *Gould v. Gould*, 245 U.S. 151 (1917).

<sup>10</sup>See, e.g., *White v. United States*, 305 U.S. 281 (1938).

<sup>11</sup>*Eisner v. Macomber*, 252 U.S. 189 (1920); *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1955); *Knight v. Commissioner*, 552 U.S. 181 (2008), Doc 2008-948, 2008 TNT 12-6.

<sup>12</sup>*CIR v. Court Holding Co.*, 324 U.S. 331 (1945).

<sup>13</sup>*CIR v. Cumberland Public Service Co.*, 338 U.S. 451 (1950).

<sup>14</sup>See *Central Tablet Mfg. Co. v. United States*, 417 U.S. 673 (1974) (stating the test).

<sup>15</sup>*General Utils. & Operating Co. v. Helvering*, 296 U.S. 200 (1935).

<sup>16</sup>*Morrissey v. CIR*, 296 U.S. 344 (1935).

<sup>17</sup>*National Carbide Corp. v. Commissioner*, 336 U.S. 422 (1949).

governing statute.”<sup>18</sup> Too bad we can’t so easily overlook the Court’s every phrase and syllable.

A third reason why many are suspicious of Supreme Court federal tax opinions is that sometimes the Court seems to make no effort to understand what is going on in the Code and just reads it straight up. For example, Justice Thomas gave us the *Gitlitz* opinion, which applied about as wooden and nonpurposive a reading to a statute as is possible.<sup>19</sup> Some might defend that as being properly subservient to the words of Congress; others might say it totally overlooks the aim of Congress.

But these examples really are not problems in the great scheme of things. As Justice Brandeis said in dissent in a federal tax case: “in most matters it is more important that the applicable rule of law be settled than that it be settled right.”<sup>20</sup> Much more important than carping about the federal tax cases we might have decided differently, is to accurately understand what the Court has done (as illustrated above in connection with *Court Holding*).

Too often federal tax opinions of the Court not only are not carefully read and parsed, but they are mythologized. They are remembered as saying things they did not say and standing for points they do not stand for. Even the Supreme Court’s tax opinions should be evaluated the way good lawyers examine all court opinions: ask what facts the Court found and what exactly was the legal holding of the Court. When we take that approach with Supreme Court opinions we find, not unexpectedly, that the tax opinions break down into those decided primarily on the facts and those decided primarily through interpretation of the law.

The classic example of a case decided on the facts is *Knetsch*.<sup>21</sup> Mr. Knetsch claimed he had borrowed \$4 million to buy some annuities. Problem was the lender was the annuity seller and there was no way Mr. Knetsch could ever pay off a \$4 million note. Nevertheless he “prepaid” a six figure amount of interest, claimed an interest deduction, and promptly borrowed back all of the interest “paid” except a small amount, which we might call a fee. The Court affirmed the trial court ruling that Mr. Knetsch did not owe a debt; therefore he could not have paid interest; whatever the payment he made was, it wasn’t for the forbearance of money borrowed. End of story.

<sup>18</sup>*Commissioner v. Bollinger*, 485 U.S. 340, 349 (1988).

<sup>19</sup>*Gitlitz v. Commissioner*, 531 U.S. 206 (2001), *Doc 2001-1085*, 2001 TNT 7-13. See Cummings, “Discharge of Indebtedness Income and the Long Tail of *Gitlitz*,” *Tax Notes*, July 7, 2008, p. 63, *Doc 2008-13499*, or 2008 TNT 131-28.

<sup>20</sup>*Burnet v. Coronado Oil & Gas*, 285 U.S. 393 (1932) (dissent; and stating the exception is constitutional law cases).

<sup>21</sup>*Knetsch v. United States*, 364 U.S. 361 (1960).

Of course *Knetsch* has been mythologized as part of the alleged economic substance doctrine’s foundation in Supreme Court decisions, but it is not. It is a garden variety fact finding case. It is also another example of a cluster rule created or at least recognized by the Supreme Court: a deductible interest payment requires the existence of an obligation that the debtor is likely to pay for money actually borrowed.<sup>22</sup> That is not an economic substance doctrine; it is a particular approach to finding the substance, which might be called the economic substance, of a transaction that a taxpayer wants to call a loan.

Another decision that has been mythologized is *Gregory v. Helvering*.<sup>23</sup> The Court ruled the distribution of an investment asset to a shareholder through a convoluted series of steps that we now would call a split-off, not to be a reorganization. What is not commonly recognized, although it was clearly seen by commentators at the time, is that *Gregory v. Helvering* is a case of statutory interpretation; that is, it is a law case not a facts case.<sup>24</sup> The facts were entirely clear and fully admitted. The question was, did the facts constitute steps “in pursuance of a plan of reorganization” of a corporation, as required by the predecessor of section 368. The Court ruled they did not because Congress required that a corporation to be reorganized as that term was commonly understood in the business world, which means some sort of business related restructuring.

However, numerous lower court tax rulings start off by stating that *Gregory v. Helvering* requires that all transactions have a business purpose, or that substance always controls form in the federal income tax, or some such gross misreading of the case.<sup>25</sup> That has been bad enough, but in about the mid 1980s courts coined a phrase “economic substance doctrine” that they applied to a positive rule of law they conflated out of the basic rules of fact finding (as in *Knetsch*) and the business purpose requirement, that could be traced in Supreme Court tax cases only to reorganizations.<sup>26</sup> The lower courts

<sup>22</sup>See Cummings, *supra* note 5, at 381 et seq.

<sup>23</sup>*Gregory v. Helvering*, 293 U.S. 465 (1935).

<sup>24</sup>See Cummings, *supra* note 5, at 87 et seq.

<sup>25</sup>See, e.g., *Fid. Int’l Currency Advisor A Fund LLC v. United States*, No. 10-2421 (1st Cir. 2011), *Doc 2011-22298*, 2011 TNT 205-31, “Tax considerations are permissibly taken into account by taxpayers in structuring their financial transactions, but where a transaction has no economic purpose other than to reduce taxes, the IRS may disregard the reported figures as fictions and look through to the underlying substance.” Citing section 7701(o) and *Gregory*.

<sup>26</sup>*Georgia Cedar Corp. v. CIR*, 1988 TCM (RIA) para. 1988-213 (the first opinion to use the phrase “economic substance doctrine”).

began to say the taxpayer that otherwise would win on the facts as normally found and the law as normally interpreted will lose if it cannot prove (1) it expected to make a profit and did not do the transaction just for tax savings (i.e., “economic substance”) and (2) it had a business purpose.

Actually this formulation might have been a reasonable cluster rule, just as *Court Holding* and *Cumberland Public Service*, and *Knetsch*, stand for cluster rules, if it had been limited to the particular scenario where it started: financed leases. Properly read, the opinion that popularized the approach to financed leases, *Rice’s Toyota*, means no more than that the purported property owner in a financed lease will not be treated as the property owner unless it can prove it could make a profit and not just produce tax losses, and so had a business purpose in addition to a tax purpose.<sup>27</sup>

But that was not to be. A mere Tax Court Memorandum decision, *ACM*, played the pivotal role in 1997 in converting what could have been a limited cluster rule for fact finding in a certain situation into a general rule of positive law, that is broader in scope than almost any other rule in the code other than the definition of gross income itself — and without benefit of action by Congress.<sup>28</sup> That led in turn to overly aggressive use of the newly created doctrine by the Chief Counsel and DOJ, and to disputes about the so called two-prong test, and finally to a bob-tailed sort of codification in section 7701(o), which really does not say anything but if a court decides to apply this thing, here is the test.

Never has a Supreme Court opinion uttered the phrase “economic substance doctrine.” Neither *Gregory*, nor *Knetsch*, nor even *Frank Lyon* (which was also a financed lease case) created or even approved of the economic substance doctrine.<sup>29</sup> Rather the Court has pursued common law fact finding in tax cases, sometimes finding that the substance of the thing done is not what the code describes. It has sometimes, but by no means universally, read uncodified requirements into tax benefits, for example business purpose, and continuity of interest and of business enterprise into the reorganization rules. But it has not created an economic substance doctrine.

I have said this many times, sometimes in the hearing or reading of the Chief Counsel. He may have responded by a statement he has made several time in speeches, as recently quoted in *Tax Notes*, that the “urban legend” that there is no economic

substance doctrine in Supreme Court case law or the code is incorrect; however, the best he could do was to assert (incorrectly) that now it is in the code.<sup>30</sup> So keep on the lookout for the economic substance case that makes it to the Supreme Court. You may find the Court saying it has never created an economic substance doctrine, and ruling for the taxpayer, or finding another way for the taxpayer to lose — the old fashioned way.

#### D. The Constitutional Cases

Turning to the Court’s federal tax constitutional case law, which is enormous, although mostly not recent, the overall impression one gets is of the fundamental expansiveness of the federal taxing power, and that the Court recognizes that and in fact created it. Tax collectors may have been unloved characters since biblical times, but the Court has almost never exhibited a prejudice against federal tax collection. It has only ruled 25 federal tax provisions unconstitutional in the entire history of the country, out of many hundreds of decisions in which it has rejected constitutional attacks.

Proof of the Court’s expansive reading of the federal taxing power includes (in addition to the 1796 carriage tax case):

- The Court has many times stated and held that the federal government can tax that which it cannot regulate, and can do so for the purpose of regulating that which it cannot regulate.<sup>31</sup>
- The United States can even force states to borrow money in a different way if they want their lenders to enjoy exempt interest.<sup>32</sup>
- Only 16 years after the *Pollock* decision striking down an income tax, the Court ruled a corporate income tax to be constitutional, even without the Sixteenth Amendment, under the ruse that it was an “excise tax,” the same lawyerly approach it used in the carriage tax case.<sup>33</sup>
- The Court has never, ever, ruled a federal tax to be unconstitutional on the grounds of discrimination by treating one taxpayer different from another, essentially permitting the Congress to tax differently based on any remotely discernible superficial difference in taxpayers. And Congress has relied heavily on that power to discriminate, as for example in customs duties, which can make seemingly arbitrary distinctions in rates between cotton and wool and other types of cloth or seeds or other products.

<sup>27</sup>*Rice’s Toyota World, Inc. v. CIR*, 752 F.2d 89 (4th Cir. 1985).

<sup>28</sup>*ACM Partnership*, T.C. Memo. 1997-115, Doc 97-6453, 97 TNT 44-17.

<sup>29</sup>*Frank Lyon Company v. United States*, 435 U.S. 561 (1978).

<sup>30</sup>Doc 2011-22694, 2011 TNT 209-3 (Oct. 28, 2011).

<sup>31</sup>See, e.g., *McCray v. United States*, 195 U.S. 27, 60 (1904) (tax on colored margarine).

<sup>32</sup>*South Carolina v. Baker*, 485 U.S. 505 (1988) (requiring registration).

<sup>33</sup>*Flint v. Stone Tracy Co.*, 220 U.S. 107 (1911).

- This lack of an equality rule in federal taxation stems in part from a fact that most of us have forgotten: there has never been an equal protection requirement in the Fifth Amendment, which is the part of the Bill of Rights that limits the federal government. Thus the Court had to make do with the tax uniformity requirement (discussed above) for 150 years or so, until the equal protection clause of the 14th amendment was read back into the Fifth Amendment in 1954. And still the Court has never ruled a federal tax unconstitutional as discriminatory.
- The Court won't let criminal non taxpayers hide behind the Fifth Amendment self-incrimination prohibition because it says the taxpayer voluntarily creates its business records and so they can't be coerced into being.<sup>34</sup>
- Turns out "no taxation without representation" is not the law in the United States.<sup>35</sup>
- And if you are mad because you don't get anything for your taxes, you are being treated exactly like the Constitution intends for you to be treated: taxes by definition are not supposed to correlate with any benefit at all to the taxpayer.<sup>36</sup>

The basic explanations for the expansiveness of federal taxation are that taxation is an oxygen level power and attribute of government and it is not limited by the Fifth Amendment, its most likely source of limitation, or by the 10th Amendment, because the Constitution is "not self-destructive."<sup>37</sup> The only limitation on federal taxation is "what free governments" in general cannot do.<sup>38</sup>

## E. Currently Pending

1. *Chevron and Mayo and Home Concrete*. The most important constitutional cases in federal taxation in recent years are the *Chevron* Doctrine cases involving deference to Treasury regulations, principally *Mayo Clinic*, the current appeal of *Home Concrete* concerning the six year statute of limitations, and the current appeal of the attack on the tax in the 2010 Affordable Care Act tax.

In 2011 in *Mayo* the Court made clear what some had wondered about, that its *Chevron* analysis ap-

plies to federal tax regulations. As a result, the Court gave deference to a Treasury regulation stating that medical residents are employees for FICA purposes, even though they are full time students too (students are exempt). The *Chevron* doctrine, stemming from a 1984 opinion of that name, directs that agency interpretations be given deference when the statute is ambiguous and the interpretation is within the realm of reason, whether or not it is the best interpretation.<sup>39</sup>

Academics probably have written more articles on the *Chevron* Doctrine in the last 20 years than any other academic topic. Most assume it effected a seismic change in the landscape of statutory interpretation. I do not. The only new thing that it and follow-on opinions really did was to sort of define when and how Congress signals its intent that an agency has power to "write the law," which means to the Court more deference should be due the regulations.

Tax folk used to think that was true only for the consolidated return regulations and a few others as to which Congress specifically directed that Treasury fill in the blanks by regulation. They were "legislative regulations," and all other Treasury regulations were called "interpretive." However, the Court has discerned that Congress in effect grants power to write the law when it leaves a gap in the statute and generally authorizes regulations, as in section 7805.<sup>40</sup>

Note that the key precondition to *Chevron* deference to the agency is the existence of a gap in the statute. Now there are intentional gaps like the authorization to write consolidated return regulations, and then there are hard to interpret statutes, and then there are simply ambiguous statutes. As to the simply ambiguous statutes, the Court says there is no one correct reading. The Court generally has grouped the ambiguous statutes with the statutes having intentional gaps; as to these the agency has broad authority to pick among reasonable meanings. But if the statute is not ambiguous, after applying normal canons of construction and interpretation, then it means what it means according to the courts, not what the agency says.

But ambiguity is in the eye of the beholder. The great fudge factor left in the *Chevron* test is whether the statute is ambiguous. For example, you might look at the words "in pursuance of a plan of reorganization" in section 368 and say it is ambiguous and so the Treasury can define it in most any way; or you might look at the legislative history and

<sup>34</sup>*United States v. Doe*, 465 U.S. 605 (1984) (although there might be some testimonial aspects of production that are protected); *Fisher v. United States*, 425 U.S. 391 (1976).

<sup>35</sup>*Heald v. District of Columbia*, 259 U.S. 114, 124 (1922).

<sup>36</sup>See, e.g., *Thomas v. Gay*, 169 U.S. 264 (1898).

<sup>37</sup>*Billings v. United States*, 232 U.S. 261 (1914).

<sup>38</sup>*Id.* at 283; *United States v. Bennett*, 232 U.S. 299, 305 (1914); *McCray*, 197 U.S. 27, 63 (1904) (unless "no free government" could pass such a law to destroy); *Knowlton v. Moore*, 178 U.S. 41, 77 (1900).

<sup>39</sup>*Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984).

<sup>40</sup>See Cummings, *supra* note 5, at 307 et seq.

see that Congress intended to remove tax roadblocks to normal restructurings of ongoing businesses for business reasons, and decide it was not ambiguous but meant just that, a meaning the Treasury cannot change. Viewed that way, the *Chevron* Doctrine is not nearly so mysterious nor is it such a huge grant of deference to the agencies.

In *Mayo* the Court said that deciding how much of a student a medical resident has to be to avoid being an employee is simply unknowable from the statute; the Court was not able to discern the correct meaning from the normal methods of statutory interpretation.<sup>41</sup> Therefore the word student is like a gap in the statute, and the Treasury acted within the realm of reason in filling it (a student working full time in the hospital is subject to the FICA tax).

The really interesting question about *Chevron* deference relates to its relationship to the Constitution: it involves the hugely important constitutional issue of the separation of powers and the relative powers of the courts, the Congress and the executive. So why is an increasingly conservative Court embracing and expanding a principle that gives more power to the executive branch, at the expense of both Congress and the courts? No one seems to have a good explanation. Perhaps it is related to the aversion of some of the Justices to looking into secondary sources for meaning of statutes; but that is hard to square with the fact that the agencies will carefully study those secondary sources. Perhaps the Court thinks giving the executive branch more rope is not particularly dangerous to the Court's powers since it can yank the rope back any time it wants to say the statute is not really ambiguous.

A current *Chevron* type case on the Court's certiorari docket is *Home Concrete*.<sup>42</sup> The issue relates to section 6501(e), which gives the IRS an extra three years to assess tax based on the omission of gross income. The IRS says gross income is omitted when basis is overstated, which happened a lot in "tax shelter" cases. The taxpayers say that the whole purpose of the extra time is to help the IRS find items that are not reflected at all on the return, rather than items that are there but calculated incorrectly. The Court has agreed to hear the appeal in *Home Concrete*, in which the Fourth Circuit ruled for the taxpayer, limiting the limitations period to three years. There is a conflict in the circuits.

Turns out the Court decided this issue in 1958 in *Colony* under a slightly different version of the same

statute.<sup>43</sup> Justice Black in *Colony* understood that gross income means gross amount realized minus basis, and he understood that could lead to finding that an overstatement of basis was an understatement of gross income; but he also saw that Congress had used the word "omits," which is still in the statute. That word, plus the logical idea that Congress thought the IRS needed more time to ferret out understatements when the item did not appear at all in the return, convinced the Court to rule that an overstatement of basis is not an omission of an item of gross income.

The academic press and the parties will try to make a huge *Chevron* issue out of the appeal, but it likely will come down to the Court's reliance on its 1958 holding. The *Chevron* issue as well as a potential constitutional issue stem from the fact that on September 28, 2009, temporary regulations (TD 9466) regarding the definition of an omission from gross income for purposes of the six-year period for assessment were published in the Federal Register.<sup>44</sup> The temporary regulation was stated to be retroactive to apply to years as to which the period for assessment had not closed on September 24, 2009. Apparently that meant the six year period had not closed. The temporary regulations made clear that basis overstatement is an omission of gross income.

The year at issue in *Home Concrete* was 1999. One would have thought that the 2009 regulation could have no relevance to it, even if it got *Chevron* deference. However, one would be wrong, according to the Justice Department. It argued in *Home Concrete* that the "six-year period for assessing tax" in section 6501(e)(1) remains open for "all taxable years . . . that are the subject of any case pending before any court of competent jurisdiction (including the United States Tax Court and Court of Federal Claims) in which a decision had not become final (within the meaning of [26 U.S.C. section] 7481)." Because *Home Concrete* was not finally resolved as of September 24, 2009, the IRS argued that section 6501(e)(1)'s six-year period for assessing tax remains open and Treasury Regulation section 301.6501(e)-1(e) applies. The Fourth Circuit rejected that argument.

The IRS has always thought that its interpretive rulings could be infinitely retroactive because it was just saying what the law has always been. However, if a regulation is to receive *Chevron* deference, then presumably the regulation is selecting a meaning that did not previously clearly exist because the statute has a range of possible meanings. It is not

<sup>41</sup>*Mayo Foundation for Medical Education and Research v. United States*, 131 S. Ct. 704 (2011), Doc 2011-609, 2011 TNT 8-10. See Cummings, "Mayo Clinic Decision Does Not Insulate Treasury Regulations from Invalidation," 21 DTR J-1 (Feb. 1, 2011).

<sup>42</sup>*Home Concrete & Supply LLC v. United States*, 634 F.3d 249 (4th Cir. 2011), Doc 2011-2674, 2011 TNT 26-7.

<sup>43</sup>*The Colony Inc. v. CIR*, 357 U.S. 28 (1958).

<sup>44</sup>74 Fed. Reg. 49321.

entirely clear why Treasury should be able to make that selection retroactive, particularly in light of the heightened sensitivity the Court has shown to retroactive tax rules. The Court has ruled unconstitutional three federal tax rules for being retroactive, which is a very heavy concentration of the small number of unconstitutional federal taxes.<sup>45</sup>

**2. Healthcare tax.** Finally, the Court announced on November 14, 2011, that it will hear an appeal from the Eleventh Circuit ruling striking down the so-called “individual mandate” in the 2010 Affordable Care Act.<sup>46</sup> Very likely this is the only live case about the constitutionality of a federal tax in the Supreme Court that most readers have ever heard about. Pundits predict the Court will rule in late June, 2012, just before its summer recess (and the fall elections). The case is about the scope of the Commerce Clause powers of the Congress, the so-called reserved powers of the states under the 10th Amendment, and the scope of the taxing power. The simple answer to the suit is that Congress wins if the tax is a tax, or if the Commerce Clause authorizes the regulation of health care and the tax is necessary and proper to carry out the regulation.

New section 5000A of the code imposes a “penalty” as part of Subtitle D, Miscellaneous Excise Taxes. The first sentence of the section provides:

An applicable individual shall for each month beginning after 2013 ensure that the individual, and any dependent of the individual who is an applicable individual, is covered under minimum essential coverage for such month.

There are several ways taxpayers can avoid the “penalty,” and the “penalty” amount is not huge. The tax has several unusual features, including that the IRS can collect it only by withholding from refunds.

The Fox News headline explaining why the excise tax is unconstitutional generally goes something like this: the law requires Americans to purchase an expensive product “from birth to death” and taxes the refusal to buy that product; therefore it invades individual liberties and the rights of the states to regulate healthcare. The actual issues designated to be argued in the 5 1/2 hour marathon session in March are slightly more formal in statement:

<sup>45</sup>*Nichols v. Coolidge*, 274 U.S. 531 (1927); *Blodgett v. Holden*, 275 U.S. 142 (1927) and *Untermeyer v. Anderson*, 276 U.S. 440 (1928); *Heiner v. Donnan*, 285 U.S. 312 (1932).

<sup>46</sup>*Florida v. United States HHS*, 648 F.3d 1235 (11th Cir. 2011). See Cummings, “‘Individual Mandate’ Stricken,” *Tax Notes*, Sept. 5, 2011, p. 1065, *Doc 2011-17976*, or *2011 TNT 172-7*.

1. “Whether the suit brought by respondents to challenge the minimum coverage provision of the Patient Protection and Affordable Care Act is barred by the Anti-Injunction Act, 26 U.S.C. 7421(a)” (from no. 11-398; the government’s appeal).

2. “Whether Congress had the power under Article I of the Constitution to enact the minimum coverage provision” (from no. 11-398; the government’s appeal). “Congress effected a sweeping and comprehensive restructuring of the Nation’s health-insurance markets in the Patient Protection and Affordable Care Act, Pub. L. No. 111-148, 124 Stat. 119 (2010), as amended by the Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, 124 Stat. 109 (2010) (collectively, the “ACA” or “Act”). But the Eleventh Circuit and the Sixth Circuit now have issued directly conflicting final judgments about the facial constitutionality of the ACA’s mandate that virtually every individual American must obtain health insurance. 26 U.S.C. section 5000A. Moreover, despite the fact that the mandate is a “requirement” that Congress itself deemed “essential” to the Act’s new insurance regulations, 42 U.S.C. section 18091(a)(2)(I), the Eleventh Circuit held that the mandate is severable from the remainder of the Act. The question presented is whether the ACA must be invalidated in its entirety because it is non-severable from the individual mandate that exceeds Congress’ limited and enumerated powers under the Constitution (from no. 11-393, and 11-400; the tax opponents’ appeal).

3. “Does Congress exceed its enumerated powers and violate basic principles of federalism when it coerces States into accepting onerous conditions that it could not impose directly by threatening to withhold all federal funding under the single largest grant-in-aid program, or does the limitation on Congress’s spending power that this Court recognized in *South Dakota v. Dole*, 483 U.S. 203 (1987), no longer apply?” (from No. 11-400; the states’ appeal).

The core issue about the power to levy the tax is the one about the Article I power. Article I of the Constitution contains both the federal power to tax and the federal power over interstate commerce. The Congress presumably relied on both powers and the Eleventh Circuit found neither to justify the tax.

The problem with Eleventh Circuit’s no tax, no regulation, position is that it ignores the last 75 years of Supreme Court jurisprudence. The Court

has not since 1936 ruled a federal tax unconstitutional because it disagreed with Congress' determination that a tax was a tax. Even in the fourteen year period from 1922 through 1936 when it was ruling that taxes were not taxes, in the majority of the cases the taxes were not intended to raise any money; here Congress counted on funds being raised by this tax. In addition the Court did not rule any federal statute to be beyond Congress' interstate commerce powers between 1936 and 1995, and has since done so only twice, including the 1995 ruling.<sup>47</sup>

When you first walk up to a constitutional argument you frequently will be struck with a contention that seems plausible, but is wrong. For example, the opponents of the health care tax may argue that taxes can't regulate but are supposed to just raise revenue for the general welfare. Well, that's wrong. As shown above, taxes regulate all the time. Tariffs regulate what goods are imported. Cigarette and liquor taxes regulate how many cigarettes are smoked and liquor drunk. The federal marijuana and narcotics taxes regulated those products back into the early twentieth century. Other evidences that federal taxes can regulate include:

- One hundred percent of the rulings against federal tax provisions on grounds even remotely similar to those charged against the health care tax occurred during the fourteen year period 1922 to 1936, and were issued by the same Court that brought us the *Lochner*, *Hammer v. Dagenhart*, and *Child Labor Tax Case* decisions,<sup>48</sup> and others into the 1930s, basically preventing state legislatures and the Congress from playing any role in economic life to protect workers through wage and hour laws and child labor laws, and to try to offset the economic dislocations of the Depression.
- That small trend of decisions ended in 1937 when the Court finally saw the handwriting on the wall and approved the social security and unemployment security systems taxes.<sup>49</sup>
- The unemployment security problem of 1937 is remarkably similar to the healthcare problem of today: they both begin as local economic problems that gained national consequences as the whole nation was out of work in the 1930s, and as tens of millions of Americans are without healthcare today, and healthcare costs are skyrocketing. A solution that required tax payments was reasonable for the unemployment problem and a solution that requires tax payments is reasonable for the healthcare problem. Reasonableness does not require that it fit into a particular Justice's socio-economic theories. As Justice Homes said in dissent in *Lochner*: "This case is decided upon an economic theory which a large part of the country does not entertain. . . . [and the 14th Amendment does not] enact Mr. Herbert Spencer's Social Statics . . . a constitution is not intended to embody a particular economic theory, whether of paternalism and the organic relation of the citizen to the state or of laissez faire." Requiring people to buy health insurance on pain of a tax is no different from requiring car owners to buy auto insurance, on pain of not being allowed to drive on the roads, or requiring home construction to have certain fire safety features so as to prevent fires from spreading from one house to another. The court has never stricken down a mandatory auto insurance plan or a zoning ordinance on grounds such as are charged against the health care tax.
- And finally, the court has a long track record of ruling favorably on federal taxes that were not even designed to raise revenue but were only designed to regulate something that even the United States admitted it could not regulate under the Constitution, an admission that the United States does not make in the case of health care. The poster child of these cases is *McCray*, a 1904 decision allowing Congress to tax colored margarine that was colored to fool people into thinking it was butter.<sup>50</sup> Congress wasn't trying to collect revenues; it was trying to stop the coloring of margarine. Congress did not think it had the direct power to regulate local margarine sales and it did not limit the tax to interstate commerce, so it was not relying on the Commerce Clause; it was relying solely on using the taxing power to regulate, and the Court agreed. What political party one might ask designed this dastardly end run around states' rights? It was the Republican

<sup>47</sup>*United States v. Lopez*, 514 U.S. 549 (1995) (reasoning that because carrying guns around schools was not economic activity, as to which the Commerce Clause has broader reach, it did not have "substantial effect" on interstate commerce; and that deference to Congress' determinations has limits); *United States v. Morrison*, 529 U.S. 598 (2000) (invalidated a section of the Violence Against Women Act of 1994, 42 U.S.C. section 13981, which provided a federal civil remedy for victims of gender motivated violence).

<sup>48</sup>*Lochner v. New York*, 198 U.S. 45 (1905); *Hammer v. Dagenhart*, 247 U.S. 251 (1918); *J.W. Bailey v. Drexel Furniture Co.*, 259 U.S. 20 (1922).

<sup>49</sup>*Helvering v. Davis*, 301 U.S. 619, 640 (1937) (social security tax); *Steward Machine Co. v. Davis*, 301 U.S. 548 (1937) (unemployment tax).

<sup>50</sup>*McCray v. United States*, 195 U.S. 27 (1904).

Party, which was trying to protect its Midwestern dairy farmer voting base.

## F. Conclusion

The federal taxing power is great in scope and the Court has played an essential role in making it so, up to now. If the Court rejects the healthcare tax, it will have turned the country's clock back to 1936, or at least attempted to, but unfortunately, even the Supreme Court cannot stop the passage of times and events. As Professor Kermit Roosevelt III, the great-great-grandson of U.S. President Theodore Roosevelt, has written, the Supreme Court turned away from its conservative "substantive due process" limitations on government action in 1937 because it realized they just were not working. In the 1930s the realization grew, both outside and within the Court, that the Court's application of the doctrinal principle of due process, based on defining Congress' power in terms of categories, resulted in decisions that were not in the public interest. In other words the proof was not in the pudding: results of applying the doctrine of limited power/due process didn't work in practice (although this epiphany was by no means universal, and did not necessarily reflect only objective analysis, but also a combination of power politics and institutional self-preservation on the part of the Supreme Court).<sup>51</sup>

Perhaps cooler heads on the Court will see in 2012 as in 1937 that turning back the clock does not work out well for the country in constitutional matters. None other than Thomas Jefferson said toward the end of his life:

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<sup>51</sup>Kermit Roosevelt III, "Forget the Fundamentals: Fixing Substantive Due Process," 8 *U. Pa. J. Const. Law* 983 (2006).

Some men look at constitutions with sanctimonious reverence, and deem them like the ark of the covenant, too sacred to be touched. . . . I am certainly not an advocate for frequent and untried changes in laws and institutions. . . . But I know also that laws and institutions must go hand in hand with the progress of the human mind. As that becomes more developed, more enlightened, as new discoveries are made, new truths disclosed, and manners and opinions change with the change of circumstances, institutions must advance also, and keep pace with the times. We might as well require a man to wear still the coat which fitted him when a boy, as civilized society to remain ever under their barbarous ancestors.<sup>52</sup> [Referring to the Founding Fathers, of which he was one.]

Alternately, cooler heads may not prevail and the Court will rule much as it did in 1922 when it struck down the tax designed to persuade cotton mills not to employ children for long hours. The 2012 opinion might even cite Chief Justice William Howard Taft's immortal words in that opinion:

In the light of these features of the act, a court must be blind not to see that the so-called tax is imposed to stop the employment of children within the age limits prescribed. Its prohibitory and regulatory effect and purpose are palpable. All others can see and understand this. How can we properly shut our minds to it?<sup>53</sup>

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<sup>52</sup>The inscription on the panel of the southeast interior wall of the Jefferson Memorial is redacted and excerpted from a letter July 12, 1816, to Samuel Kercheval. Quoted in Richard Hofstadter, *The American Political Tradition* 55 (1974 Vintage edition).

<sup>53</sup>*J.W. Bailey v. Drexel Furn. Co.*, 259 U.S. 20, 37.