

# INTERPRETING TAX STATUTES: WHEN ARE STATUTORY PRESUMPTIONS JUSTIFIED?

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## TABLE OF CONTENTS

I.	THE SIGNIFICANCE OF PRESUMPTIONS .....	390
II.	THE LAW DISFAVORS STATUTORY PRESUMPTIONS.....	393
III.	PRESUMPTIONS ARE NOT ALWAYS A BAD THING .....	398
IV.	NARROWLY CONSTRUING DEDUCTIONS.....	401
	A. <i>What's so Gracious About Giving a Deduction?</i> ...	402
	B. <i>Deductions are not an Exception to Capitalization</i> .....	405
V.	BROADLY CONSTRUING BUSINESS DEDUCTIONS .....	407
VI.	CONCLUSION .....	408

Every tax lawyer has heard countless times that deductions are a matter of legislative grace and should therefore be narrowly construed.<sup>1</sup> This incantation—which in effect invokes a statutory presumption—has the unfortunate effect of denying deduction that might otherwise have been permitted. Held in awe, like a mantra, it reverberates through over 1000 court cases and IRS rulings.<sup>2</sup> The proposition is as perverse as it is

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1. *INDOPCO, Inc. v. Comm'r*, 503 U.S. 79, 84 (1992); *Interstate Transit Lines v. Comm'r*, 319 U.S. 590, 593 (1943); *Deputy v. Du Pont*, 308 U.S. 488, 493 (1940); *New Colonial Ice Co. v. Helvering*, 292 U.S. 435, 440 (1934).

2. *See, e.g.*, cases, *supra* note 1; I.R.S. Field Service Advice 200219001 (May 10, 2002). In a recent Westlaw search, the search term “deduction! / 5 ‘legislative grace” pulled up 1165 hits.

## 390 HOUSTON BUSINESS AND TAX LAW JOURNAL [Vol. IV

pervasive, however. The purpose of this article is to explore the justification for this statutory presumption,<sup>3</sup> and more generally, to determine whether, and when, statutory presumptions are ever justified in the interpretation of tax statutes.

This article first explores the evolution of statutory presumptions in the tax context and suggests that tax statutes should be interpreted without resort to presumptions, barring the existence of evidence suggesting Congress intended a broad or narrow construction. That is, statutory construction should start with a presumption against presumptions. Next, the article critiques existing presumptions and argues on behalf of ones that should stay and against ones that should go. Finally, the article discusses two presumptions courts should but often do not recognize: namely, the liberal application of business deductions<sup>4</sup> and incentive tax credits.<sup>5</sup>

## I. THE SIGNIFICANCE OF PRESUMPTIONS

Before engaging in a discussion about presumptions, one should consider why tax practitioners and litigators should care about presumptions. Are presumptions significant? There is no question that litigants in all areas of the law commit precious resources and wage epic battles over presumptions.<sup>6</sup> But cynics might say that the presence of presumptions has no real impact on the outcome of cases, that they are mere hyperbole that judges insert in their opinions after they've already decided the case. One might contend that they are merely after-the-fact rhetoric, that is courts rely on them as the proverbial intoxicated man relies on a lamppost upon stumbling out of a pub—for support, not illumination. After all, how many cases explicitly acknowledge

3. MICHAEL I. SALTZMAN, IRS PRACTICE AND PROCEDURE ¶ 7B.02[3][c] (2003) (A statutory presumption “generally ‘imposes on the party against whom it is directed the burden of going forward with evidence to rebut or meet the presumption.’”) (citing Fed. R. Evid. 301).

4. See generally, I.R.C. §§ 162, 263 (2000).

5. See, e.g., I.R.C. § 21 (2000) (child care credit); I.R.C. § 43 (2000) (enhanced oil recovery credit); I.R.C. § 45D (2000) (new markets tax credit).

6. See generally, 2A NORMAN J. SINGER, STATUTES AND STATUTORY CONSTRUCTION § 38.8 (6<sup>th</sup> ed. 2001). See *Welch v. Helvering*, 290 U.S. 111, 115 (1933); *Cebollero v. Comm’r*, 967 F.2d 986, 990 (4th Cir. 1992), *aff’g* T.C. Memo 1990-618; *Demkowicz v. Comm’r*, 551 F.2d 929, 931 (3d Cir. 1977); JACOB MERTENS, JR., LAW OF FEDERAL INCOME TAXATION § 50:485 (2004); Stephen G. Salley & Anthony J. Scaletta, *The Incredible Taxpayer: The U.S. Tax Court and I.R.C. § 7491*, 77 FLA. B.J. 80 (June 2003). *Helvering v. Taylor*, 293 U.S. 507, 515 (1935); *Cullers v. Comm’r*, 237 F.2d 611, 614 (8th Cir. 1956); *Hemphill Schools, Inc. v. Comm’r*, 137 F.2d 961, 963–64 (9th Cir. 1943); *Estate of Mitchell v. Comm’r*, 250 F.3d 696, 702 (9th Cir. 2001); *Llorente v. Comm’r*, 74 T.C. 260, 264 (T.C. 1980); *Shell Oil Co. v. Comm’r*, 89 T.C. 371, 409 n.22 (T.C. 1987); JACOB MERTENS, JR., LAW OF FEDERAL INCOME TAXATION § 50:485 (2004). SALTZMAN, *supra* note 3.

that the case turned on whether the statute was accorded a narrow or broad interpretation?

Those who have experienced the decision-making process from the judges' side of the bench, however, are more likely to assign significance to statutory presumptions. Many would probably agree that in the tough cases—on the close calls—presumptions can make a real difference. In these matters, presumptions often establish the foundation on which decisions are built. They frame the canvas on which judges paint, and nudge judges this way or that towards a particular conclusion. Presumptions provide a backdrop against which cases are decided, and thus impact the way judges approach issues. In short, where there are tough calls to be made, presumptions can make or break the case.

Moreover, presumptions can have an even more profound effect when the government bears the burden of proof.<sup>7</sup> The statutory presumption that deductions should be narrowly construed is particularly illustrative.<sup>8</sup> Because the proposition is a rule of statutory construction, it is not affected by a shift in the burden of proof.<sup>9</sup> Thus, the situation will often arise where the government bears the burden of proving the fact that a deduction does not apply, while there is also a presumption against the taxpayer that the deduction is narrow in scope.<sup>10</sup> Although in theory this may not be inconsistent, in practice the presumption can cancel the effect of having the burden of proof.<sup>11</sup> It results in

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7. In the tax litigation context, the government bears the burden of proof with respect to new matters, increases in deficiency, and affirmative defenses (*see* TAX CT. R. PRAC. 142(a); *Shea v. Comm'r*, 112 T.C. 183, 191 (T.C. 1999)), certain types of fraud (*see* I.R.C. § 7454 (2000)), in certain situations where the taxpayer has introduced credible evidence, maintained all required records, and cooperated with the government (*see* I.R.C. § 7491 (2000)), and arbitrary and erroneous notices of deficiency in unreported income cases (*Dellacrocce v. Comm'r*, 83 T.C. 269 (T.C. 1984)), for example.

8. *INDOPCO, Inc. v. Comm'r*, 503 U.S. 79, 84 (1992); *Deputy v. Du Pont*, 308 U.S. 488, 493 (1940); *New Colonial Ice Co. v. Helvering*, 292 U.S. 435, 440–41 (1934); *see also* Calvin H. Johnson, *The Expenditures Incurred by the Target Corporation in an Acquisitive Reorganization are Dividends to the Shareholders*, 53 TAX NOTES 463, 478 (1991) (noting that the “strong law of capitalization” is important to the taxing regime).

9. Steve R. Johnson, *The Dangers of Symbolic Legislation: Perception and Realities of the New Burden-of-Proof Rules*, 84 IOWA L. REV. 413, 441–42 (1999). In certain instances, such as where the government raises new matters in the Tax Court (*see* TAX CT. R. PRAC.142(a)), or where the taxpayer satisfies certain burden-shifting requirements (*see* I.R.C. § 7491(a) (2000)), or in certain bankruptcy situations, the government has the burden of proof. But rules of statutory construction are not affected by shifts in the burden of proof. In case there is doubt about this: Presumptions are based on analysis of language and structure of the Code. Regardless of where the burden of proof lies, the language and structure of the Code remains the same. Thus, even if the burden shifts, the taxpayer must still contend with an ominous statutory presumption.

10. *See Keough v. Comm'r*, 713 F.2d 496, 501 (9th Cir. 1983).

11. *Id.*

## 392 HOUSTON BUSINESS AND TAX LAW JOURNAL [Vol. IV

a confused analysis and has the potential to weaken or eviscerate a burden that is properly placed on the government.

To illustrate, suppose the government has the burden of proof in a particular civil case,<sup>12</sup> and thus must prove by a preponderance of the evidence<sup>13</sup> that there is a greater than 50 percent likelihood the facts of the case do not bring the taxpayer within the meaning of the statute. But, if at the same time the court applies a presumption that deductions are narrowly construed, the law will be read in a manner in which it is more difficult to fit the facts within the statute. Consequently, the application of a statutory presumption against deductions will to a large extent negate any benefit the taxpayer would receive from shifting the burden of proof. Moreover, in practice, courts often blur the distinction between the burden and the proposition that deductions are narrowly construed, resulting more often than not in a higher hurdle for the taxpayer.

The importance of statutory presumptions, in fact, is somewhat analogous to burdens of proof, the importance of which has also been subject to debate. Burdens of proof, too, are often more important than some judges let on. For instance, during the debates over shifting the burden of proof to the government, opinions were expressed that burdens of proof make little difference because cases rarely turn on the burden of proof.<sup>14</sup> After all, in theory, a preponderance of the evidence burden only helps if the evidence on both sides is equipose. But in practice, it would be naive to think this is true. In reality, having the burden on your side is worth much more than an additional 1 percent of the evidence in a situation where the evidence is equipose.<sup>15</sup> Like burdens of proof, statutory presumptions are more than mere tiebreakers.

The question might be asked then: If presumptions are indeed so important, why have they largely escaped scrutiny?

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12. As noted in Tax Court Rule 142(a), the government bears the burden of proof when it brings up "new matters." The government bears such burden only with respect to such new matter. In addition, the following require the government to bear the burden of proof: (1) Fraud (TAX CT. R. PRAC. 142(b), I.R.C. § 7454(a) (2000)), (2) Foundation Managers; Trustees; Organization Managers (TAX CT. R. PRAC. 142(c), I.R.C. § 7454(b) (2000)), (3) Transferee Liability (TAX CT. R. PRAC. 142(d), I.R.C. § 6902(a) (2000)), and (4) Accumulated Earnings Tax (TAX CT. R. PRAC. 142(e)).

13. Johnson, *supra* note 9, at 444.

14. *Burden-of-Proof Provision Could Spur Disputes, Tax Court Chief Judge Says*, 98 TAX NOTES TODAY 12-58 (Jan. 20, 1998) (reproducing letter from Chief Judge Mary Ann Cohen to Senators William V. Roth, Jr. and Daniel Patrick Moynihan); Kip Dellinger, *A Substitution for Shifting the Burden in Ordinary Tax Disputes*, 97 TAX NOTES TODAY 240-93, n.2 (Dec. 15, 1997) (stating that "the rather elusive nature of the burden of proof in many types of cases will likely render the shift toothless.").

15. Johnson, *supra* note 9, at 438-39, 444.

The probable reason is that there is rarely an appropriate opportunity to challenge presumptions. Courts rarely, if ever, squarely confront presumptions,<sup>16</sup> because litigants rarely build an argument around a presumption; that is they rarely frame the issue in terms of whether a statutory provision should be construed broadly or narrowly. Doing so would risk creating the perception that the litigant needs a favorable presumption to win.<sup>17</sup> Many litigants would be concerned that putting too much emphasis on whether deductions should be broadly or narrowly construed may imply that their case hinges on the breadth of the statute. It is customary, and in fact advisable in most cases, to take the position that a deduction is warranted under any reasonable interpretation of the statute, so statutory presumptions are academic. Also, emphasizing the breadth of deductions may distract the court from the real issue in the taxpayer's case. For these reasons, presumptions seldom come squarely before a court.

Similarly, statutory presumptions are unlikely to receive the attention of lobbyists and legislators. They are typically judicial constructs that are designed to give effect to Congress' intent and are not typically written into law by legislators.<sup>18</sup> Is Congress likely to pass a law that deductions are not a matter of legislative grace? Such matters are normally not within the purview of the legislative branch of government.<sup>19</sup> Thus, there is really no logical or likely venue for statutory presumptions to be addressed, despite their importance.

## II. THE LAW DISFAVORS STATUTORY PRESUMPTIONS

Arguably, in the absence of statutory language to the contrary or a compelling public policy reason, tax statutes should be construed without presumptions.<sup>20</sup> As Erwin Griswold, former U.S. Solicitor General under Presidents Johnson and Nixon and

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16. For an example of a case where the Supreme Court analyzed a statutory presumption, see *Landgraf v. USI Film Products*, 511 U.S. 244 (1994).

17. See John Valery White, *The Irrational Turn in Employment Discrimination Law: Slouching Toward a Unified Approach to Civil Rights Law*, 53 MERCER L. REV. 709, 787-88 (2002).

18. Legislators, however, have taken the opportunity to comment favorably in the legislative history about certain presumptions. See, e.g., H.R. CONF. REP. NO. 105-599, at 238 (1998) (recognizing that the "presumption in favor of the Commissioner is a procedural device that requires the plaintiff to go forward with prima facie evidence to support a finding contrary to the Commissioner's determination.").

19. *Id.* at 540.

20. See *Landgraf*, 511 U.S. at 270-72 (1994); see McGee Grigsby & Cheryl Coe, *The "Norm of Capitalization:" An Unwarranted Presumption*, 77 TAXES 31 (Mar. 1, 1999).

## 394 HOUSTON BUSINESS AND TAX LAW JOURNAL [Vol. IV

former Dean of Harvard Law School, remarked:

[T]here is no reason why there should be any burden one way or the other in the construction of a statute. In all cases the function of the court should be simply to decide what that construction fairly should be. The question may indeed be close—otherwise it would probably not be in court—but it is nonetheless the function of the court to resolve it.<sup>21</sup>

Notwithstanding Mr. Griswold's comments, throughout the better part of the last century, the courts have struggled over the application of statutory presumptions in the analysis of tax statutes.<sup>22</sup>

To understand the current state of the law, it is useful to study the tortuous history of how it evolved into what it is today.

The journey begins in 1917, when, in one of the earliest cases under the modern income tax, the U.S. Supreme Court set forth a presumption in favor of taxpayers.<sup>23</sup> In *Gould v. Gould*, the Court stated:

In the interpretation of statutes levying taxes it is the established rule not to extend their provisions, by implication, beyond the clear import of the language used, or to enlarge their operations so as to embrace matters not specifically pointed out. In case of doubt they are construed most strongly against the Government, and in favor of the citizen.<sup>24</sup>

This rationale was set forth further by the Court in *United States v. Merriam*, in which the Court reiterated the statement in *Gould* and stated that a presumption against the Government is

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21. Erwin N. Griswold, *An Argument Against the Doctrine that Deductions Should Be Narrowly Construed as a Matter of Legislative Grace*, 56 HARV. L. REV. 1142, 1144 n.10 (1943) (internal quotes omitted).

22. See Sean M. Moran, *The Presumption of Correctness: Should the Commissioner be Required to Carry the Initial Burden of Production*, 55 FORDHAM L. REV. 1087, 1089–91 (1987).

23. *Gould v. Gould*, 245 U.S. 151, 153 (1917).

24. *Id.*

firmly rooted in the Anglo-origins of the tax laws.<sup>25</sup> Quoting Lord Cairns' statement in *Partington v. Attorney-General*,<sup>26</sup> which emphasized that certainty and clarity is necessary in a statute before it can be used to levy a tax on a particular person, the *Merriam* Court stated:

I am not all sure that, in a case of this kind—a fiscal case—form is not amply sufficient; because, as I understand the principle of all fiscal legislation, it is this: If a person sought to be taxed comes within the letter of the law he must be taxed, however great the hardship may appear to the judicial mind to be. On the other hand, if the Crown, seeking to recover the tax, cannot bring the subject within the letter of the law, the subject is free, however apparently within the spirit of the law the case might otherwise appear to be. In other words, if there be admissible in any statute, what is called an equitable construction, certainly such a construction is not admissible in a taxing statute, where you can simply adhere to the words of the statute.<sup>27</sup>

Thus, before the government can confiscate a person's property in the name of State sovereignty and subject the property to taxation, it must show that the property of thing to be taxed comes squarely within the statute. For approximately 15 years, the *Gould* decision shaped judicial interpretation of tax cases by instituting a presumption in favor of the taxpayer where the breadth of the statute was unclear.

However, in a line of cases, beginning with *Burnet v. Guggenheim*,<sup>28</sup> *New Colonial Ice Co. v. Helvering*,<sup>29</sup> and culminating in *White v. U.S.*,<sup>30</sup> the Supreme Court retreated from its position that there should be a presumption in favor of the taxpayer and seemed to set forth the principle that presumptions should not be implied in the normal case.<sup>31</sup> In *White*, the Court stated:

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25. U.S. v. Merriam, 263 U.S. 179, 188 (1923).

26. LR 4 H.L. 100, 122 (1869).

27. *Merriam*, 263 U.S. at 188.

28. 288 U.S. at 286 (1933).

29. 292 U.S. at 440 (1934).

30. 305 U.S. at 292 (1938).

31. *Id.*

We are not impressed by the argument that, as the question here decided is doubtful, all doubts should be resolved in favor of the taxpayer. It is the function and duty of courts to resolve doubts. We know of no reason why that function should be abdicated in a tax case more than in any other where the rights of suitors turn on the construction of a statute and it is our duty to decide what that construction fairly should be.<sup>32</sup>

Commenting on this line of cases and the newfound *White* principle, Dean Griswold remarked: “This seems an obviously sound approach to the problem of the construction of taxing statutes, and we are well rid of the thought-deadening formula of the prior cases.”<sup>33</sup>

This, however, is not the end of the story. Approximately five years later, the Court turned 180 degrees and without analysis or an articulated rationale embraced a presumption in favor of the government.<sup>34</sup> This about-face occurred in *Interstate Transit Lines v. Commissioner*.<sup>35</sup> In deciding *Interstate Transit*, the Court spawned the principle that deductions are a matter of legislative grace.<sup>36</sup> This principle arose from nothing, like a phoenix from the ashes, without rationale, and without justification.<sup>37</sup> The Court simply referred to it as “the now familiar rule that an income tax deduction is a matter of legislative grace and that the burden of clearly showing the right to the claimed deduction is on the taxpayer.”<sup>38</sup>

Perhaps the *Interstate Transit* Court’s legislative grace language largely escaped scrutiny at the time because it was understood to merely be poetic prose to precede the statement

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32. *Id.*

33. Griswold, *supra* note 24, at 1143.

34. *Interstate Transit Lines v. Comm’r*, 319 U.S. 590, 593–94 (1943).

35. *Id.* The legislative grace language actually occurred in *White* (and even in a few pre-*White* cases), but within the context of describing the duty of courts to interpret statutes without presumptions; however, the legislative grace language did not take on the meaning it did in *Interstate Transit*. *White*, 305 U.S. at 292.

36. 319 U.S. at 593.

37. One possible hypothesis is that in 1943, because the United States was engulfed in World War II, the government simply needed additional revenue. James W. Colliton, *Standards, Rules and the Decline of the Courts in the Law of Taxation*, 99 DICK. L. REV. 265, 297 (1995).

38. *Interstate Transit Lines*, 319 U.S. at 593.



that the burden of proof is generally on the taxpayer.<sup>39</sup> If this were all it stood for it would have been relatively unremarkable. Unfortunately, subsequent decisions have demonstrated that the legislative grace comment means much more.<sup>40</sup> It became the all too important proposition that deductions should be narrowly construed, that is, a presumption about how certain statutory provisions should be interpreted.<sup>41</sup> Thus, the Court went from neutralizing a statutory construction that favored the taxpayer to a presumption that favored the government.<sup>42</sup>

Talk about a 180 degree turn. A mere five years earlier, the Court had stated, in tones of indignation, that a statutory presumption favoring the taxpayer represented an abdication of the courts' responsibilities.<sup>43</sup> Now that the presumption was favorable to the government the Court appeared to change its position, sanctioning a statutory presumption even though no justification for it was given. Was there any reason the Court should regard the use of presumptions as an abdication of its responsibilities when the presumption would benefit the taxpayer but not when it would hurt the taxpayer?

One is reminded of the fable of two neighbors in rural England, one a lawyer, one a farmer. The farmer, circumspect of the lawyer's wily nature, says to the lawyer, "sir, regrettably your ox hopped over the fence separating our properties and was gored by one of my bulls, and I wish to know whether I need to make reparations". The lawyer responded that of course the farmer would have to make reparations and that he owed him one ox. To that, the farmer replied, "very good, because actually it was my ox that hopped the fence and your bull that did the goring. So I suppose you owe me one ox." The lawyer then retorted that that was a different case with different facts and therefore different principles applied. Disagreeing that there

39. This proposition is likely since the next sentence also refers to the taxpayer's burden, stating "[t]he decision of the two courts below is that this burden has not been met." *Id.*

40. See, e.g., *INDOPCO, Inc.*, 503 U.S. at 84 (1992).

41. See Grigsby & Coe, *supra* note 23, (discussing presumptions in how certain statutory provisions should be interpreted).

42. It is unclear whether pre-*White* law is still valid for tax statutes that do not involve deduction, and thus, arguably, there is now a presumption in favor of the government for statutes that involves deductions, but a presumption in favor of the taxpayer for certain other types of tax provisions. See, e.g., *B&M Co. V U.S.*, 452 F.2d 986 (5th Cir. 1971) (Following the principle of *Gould v. Gould*, 245 U.S. 151); *United States v. Brown*, 536 F.2d 117 (6th Cir. 1976); *Seaton v. Sky Reality Co.*, 491 F.2d 634 (7th Cir. 1974); *Flandreau Santee Sioux Tribe v. U.S.*, 197 F.3d 949 (8th Cir. 1999); *United States v. McGee*, 993 F.2d 184 (9th Cir. 1993); *Royal Caribbean Cruises v. U.S.*, 108 F.3d 290 (11th Cir. 1997).

43. *White v. U.S.*, 305 U.S. 281, 292 (1938).

## 398 HOUSTON BUSINESS AND TAX LAW JOURNAL [Vol. IV

could be a difference, the farmer rightfully exclaimed, “it does not depend upon whose ox is gored!”

Similarly, is it not hypocritical to reject a presumption favoring the taxpayer on the grounds that applying a presumption is an abdication of judicial responsibilities but then in the same breath create of a presumption against the taxpayer? This hypocrisy is aptly articulated by Erwin Griswold in a piece he penned for the Harvard Law Review. He wrote:

A great service was done [by the Supreme Court] when it was shown that the problem of construing tax statutes was one of finding the meaning of words, and that this was a problem which must be approached free from any rules or presumptions or other barriers to the ascertainment of the thought which Congress has expressed. But no reason is perceived why exactly the same rule should not be applied to the construction of a deduction provision. The problem is to find the meaning of what Congress said. There is no reason why that should be approached in terms of “legislative grace” or of “clear” burden on the taxpayer.<sup>44</sup>

As Dean Griswold deftly described, courts should abide by the same principle to reject presumptions in favor of the government as they do in the case of taxpayers. It should not depend upon whose ox is gored.

### III. PRESUMPTIONS ARE NOT ALWAYS A BAD THING

Although the law should disfavor presumptions, such interpretive maxims are sometimes appropriate for courts to draw upon. Four examples of such circumstances are discussed below.

First, in instances where the legislature explicitly fashions a presumption the courts should—and indeed must—honor that presumption.<sup>45</sup> For example, Congress was explicit about making

44. Griswold, *supra* note 24, at 1144–45 (emphasis added).

45. James E. Pfander, *Once More Unto the Breach: Eleventh Amendment Scholarship and the Court*, 75 NOTRE DAME L. REV. 817, 828 (2000). The Legislature’s creation of a presumption is not to be confused with Treasury Department’s attempt to create its own presumption. Treasury’s self-serving attempt to create a presumption in its own favor is illustrated in I.R.C. §4051(a)(1)(E) and the temporary regulations thereunder. Specifically, I.R.C. §4051(a)(1)(E) provides that “tractors of the kind chiefly used for highway transportation in combination with a trailer or semitrailer” are subject

a presumption in the case of double deductions and double inclusions in income.<sup>46</sup> Section 7852(c) explicitly creates a presumption that the same item (whether of income, deduction, credit, or otherwise) shall not be taken into account both in computing the present income tax and the tax under chapter 1 and 2 of the Internal Revenue Code of 1939. Thus, when interpreting a Code provision, there is a presumption that the provision should be construed in a manner that does not permit a double deduction or require a duplicative inclusion in income.

Second, there are instances where presumptions may be justified on policy grounds.<sup>47</sup> That is, presumptive maxims may be useful to ensure that ambiguities do not result in harsh, unfair consequences.<sup>48</sup> For example, it is firmly regarded that penal statutes—including civil and criminal tax penalties—are to be strictly construed.<sup>49</sup> This means that if it is not clear whether the language of a penal provision applies to the taxpayer's conduct, then the statute will be interpreted narrowly in favor of the taxpayer/defendant.<sup>50</sup> The policy behind such a rule of construction is that people should have fair warning that conduct is punishable.<sup>51</sup> In this regard, courts have repeatedly recognized that where a statute imposes a tax which is in effect a penalty,

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to a 12% excise tax upon the first retail sale of such items. Temporary Treasury Regulations §145.4051-1(e)(1)(i), which remains temporary 20 years after it was promulgated, then greatly expands the definition of "tractor" for excise tax purposes to include "a highway vehicle primarily designed to tow a vehicle, such as a trailer or semitrailer, but does not carry cargo on the same chassis as the engine. A vehicle equipped with air brakes and/or towing package will be presumed to be primarily designed as a tractor." The discrepancy between the plain language of the Code section and the self-serving temporary regulation was successfully challenged in *Horton Homes, Inc. v. United States*, 2004 WL 77918 (11th Cir. 2004). For a thorough analysis of the Code section and temporary regulation at issue in the case, which the authors titled a "permanently temporary" regulation, please see Vasquez and Lowy, *Challenging Temporary Treasury Regulations: An Analysis of the Administrative Procedure Act, Legislative Reenactment Doctrine, Deference, and Invalidity*, 3 HOUS. BUS. & TAX L.J., 248, 260–62 (2003).

46. I.R.C. § 7852(c) (2000).

47. See generally, *People v. Ramsey*, 735 N.E.2d 533, 542–44 (Ill. 2000) (stating that a presumption against statutory retroactivity will coincide with public expectations, and that Congress has considered the potential unfairness of retroactive application); *Quick v. City of Austin*, 7 S.W.3d 109, 136 (Tex. 1999) (stating that whether to apply a statute retroactively is a legislative policy choice and the presumption against retroactivity coincides with legislative and public expectations).

48. See generally MERTENS, *supra* note 6, at §§ 3:05, 3:07, 3:08, 3:09 & 3:58.

49. *Id.* at § 3:58 (specific intent to violate the law is an element of criminal tax offenses); See also *UHL Estate Co. v. Comm'r*, 116 F.2d 403, 406 (9th Cir. 1940); *Mead Corp. v. Comm'r*, 116 F.2d 187, 192 (3d Cir. 1940).

50. See MERTENS, *supra* note 6, at § 3.09.

51. See generally *United States v. Lanier*, 520 U.S. 259, 265–66 (1997) (stating that "the canon of strict construction of criminal statutes ensures fair warning by so resolving ambiguity . . . as to apply it only to conduct clearly covered.").

400 *HOUSTON BUSINESS AND TAX LAW JOURNAL* [Vol. IV

the statute should be strictly construed and should not be extended to cover cases which do not fall within its letter.<sup>52</sup> Moreover, courts have acknowledged that any ambiguities with respect to such provisions should be construed in favor of the taxpayer.<sup>53</sup>

Third, there are instances where application of a presumption is useful to ensure that a clear legislative agenda is not frustrated by an unduly narrow or broad interpretation. For example, where Congress has created an exemption from tax for charitable gifts in order to encourage such philanthropy,<sup>54</sup> the exemption provision should be construed liberally to advance the presumed policy and legislative goal behind the statute.<sup>55</sup> This would also be the case for incentive tax credits,<sup>56</sup> where a narrow construction could frustrate a legislative agenda. Liberally construing such credits is often necessary to give full force to Congress' intent to encourage certain activities.

Take the enhanced oil recovery credit found at section 43, for example.<sup>57</sup> Congress created this credit in response to the Nation's growing dependence on foreign oil and the disproportionate expense of producing from domestic fields.<sup>58</sup>

The credit offers an incentive for oil producers to continue production in the tertiary phase where enormous capital investment is necessary to pump out the oil that lies at the bottom of the reserve, thus encouraging oil companies to fully use domestic oil wells by maximizing their production.<sup>59</sup> This credit was critical to a healthy energy policy in 1974 when it was enacted, and it remains critical today.<sup>60</sup> Congress wants taxpayers to rely on these credits when they weigh their investment options, and without a liberal construction of the

52. See, e.g., *Uhl Estate Co.*, 116 F.2d at 406; *Mead Corp.*, 116 F.2d at 192.

53. *Hatfried, Inc. v. Comm'r*, 162 F.2d 628, 633 (3d Cir. 1947). See also *U.S. v. Scharton*, 285 U.S. 518, 522 (1932).

54. I.R.C. §170 (2000).

55. See, e.g., *Helvering v. Bliss*, 293 US 144, 150–51 (1934); see also, e.g., *Samuel Friedland Foundation v. U.S.* 144 F.Supp 74, 84 (D. N.J. 1956).

56. See, e.g., I.R.C. § 21 (2002) (child care credit); I.R.C. § 43 (2002) (enhanced oil recovery credit); I.R.C. § 45D (2002) (new markets tax credit).

57. I.R.C. § 43(a) provides the general rule that "[f]or purposes of section 38, the enhanced oil recovery credit for any taxable year is an amount equal to 15 percent of the taxpayer's qualified enhanced oil recovery costs for such taxable year."

58. *Increasing Domestic Oil and Gas Production, Before the House Subcomm. On Oversight, Comm. on Ways and Means*, 107<sup>th</sup> Cong. (2001) (statement of Joseph Mikrut, Tax Legislative Counsel, Dept. of the Treasury).

59. See *id.*

60. See *Advanced Oil Recovery Credit*, AMERICAN PETROLEUM INSTITUTE (July 1, 2001), available at [http://api-ep.api.org/filelibrary/EOR\\_Credit\\_2001.pdf](http://api-ep.api.org/filelibrary/EOR_Credit_2001.pdf).

credits, taxpayers will be hesitant to do so.<sup>61</sup>

Fourth, presumptions may be appropriate where verbal patterns suggest something about how a statute should be interpreted.<sup>62</sup> But looking to verbal patterns can be tricky. For example, it is a well-known canon of statutory interpretation that exceptions and provisos to the general rule should be narrowly construed.<sup>63</sup> Applying a strict construction to the Internal Revenue Code's provisions dealing with deductions and capitalization, it would seem that deductibility should be the general rule and capitalization is the exception. As a general rule, section 161 provides that deductions under various sections (specifically, sections 161-198) shall be allowed, unless an exception applies.<sup>64</sup> Section 161 then explains that the exceptions to the general rule of deductibility are delineated at sections 261-280 (these are provisions for capitalization).<sup>65</sup> Thus, application of the canon of construction that exceptions should be narrowly construed should yield the conclusion that provisions that provide for capitalization should be narrowly construed, and conversely, provisions that provide for deductions should be broadly construed.

But curiously, the courts have turned section 161 on its head, invoking the above canon of statutory interpretation to conclude that deductions should be narrowly—not broadly—construed.<sup>66</sup> This subject deserves elaboration.

#### IV. NARROWLY CONSTRUING DEDUCTIONS

As stated in the introduction of this article, one of the most prevalent presumptions in the tax law today is the notion that deductions should be narrowly construed.<sup>67</sup> Yet, this presumption is replete of any rationale basis to warrant departure from the neutral principles of statutory construction.<sup>68</sup>

61. See INTERMEDIATE MACROECONOMICS, ch. 14, § 8, available at <http://mason.gmu.edu/~edutlidderd/311/ch14/Lect.html> (last visited Apr. 4, 2004).

62. See Douglas G. Smith, *Fundamental Rights and the Fourteenth Amendment: The Nineteenth Century Understanding of "Higher" Law*, 3 TEX. REV. L. & POL. 225, 277 n.55 (Spring 1999) (noting that "canons of interpretation" are viewed as aids for statutory interpretation).

63. *Corn Products Refining Co. v. Comm'r*, 350 U.S. 46, 52 (1955); *Piedmont & Northern Ry. Co. v. Interstate Commerce Comm'n*, 286 U.S. 299, 311–12 (1932); SINGER, *supra* note 6, at § 47.11.

64. I.R.C. § 161 (2000) (emphasis added).

65. *Id.*

66. See *INDOPCO, Inc.*, 503 U.S. at 84 (1992).

67. See *id.*

68. See Peter Lowy, *Deductions Should Not Be Narrowly Construed*, 89 TAX NOTES

## 402 HOUSTON BUSINESS AND TAX LAW JOURNAL [Vol. IV

Originally, the only argument advanced to support this presumption was the legislative grace doctrine.<sup>69</sup> No court (nor the IRS) has ever explained what legislative grace has to do with statutory interpretation. Ostensibly, the legislative grace doctrine is a policy rationale. But as explained below, it does not hold water.

A. *What's So Gracious About Giving a Deduction?*

The “legislative grace” doctrine has been used by courts to deny a deduction when it is unclear whether the language of the Code permits it.<sup>70</sup> Thus it is a powerful tool for the IRS when dealing with new industries or innovative concepts.<sup>71</sup> In effect, if the language of the statute does not clearly permit a business expense deduction, the doctrine suggests that the deduction should be denied.<sup>72</sup>

What is the basis for this presumption? The basis for the presumption is seldom stated. To the extent that it is stated, it appears to be that because Congress could have permitted no deductions at all, it was a matter of legislative grace that Congress permitted each deduction.<sup>73</sup> Therefore, the argument goes, if Congress did not clearly exercise that legislative grace, it is presumed that Congress did not intend to permit any deductions.<sup>74</sup>

Dean Griswold concluded that as a matter of historical accuracy, deductions were as much a part of business income as items of income.<sup>75</sup> Indeed, since its inception, the modern-day income tax in the United States has been a tax on *net* income.<sup>76</sup> The objective of the income tax, as originally stated in 1913, is “to tax a man’s net income; that is to say, what he has at the end of the year after deducting from his receipts his expenditures and

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1181 (Nov. 27, 2000).

69. See *New Colonial Ice Age, Co., Inc. v. Helvering*, 292 U.S. 435, 440 (1934).

70. See *INDOPCO*, 503 U.S. at 84, 90.

71. In *INDOPCO*, the Supreme Court addressed whether banking and legal expenses incurred in connection with a legal takeover qualified for a deduction as ordinary and necessary business expenses. *Id.* at 80–83.

72. See Lowy, *supra* note 73, at 1181–82.

73. See, e.g., *Klassen v. Comm’r*, 76 T.C.M. (CCH) 20, 23 (1998) (stating, “the decision whether to permit particular deductions and under what circumstances lies within the discretion of Congress”) (referencing *New Colonial Ice Co. v. Helvering*, 292 U.S. 435, 440 (1934)).

74. *Id.*

75. Griswold, *supra* note 24, at 1144.

76. *Comm’r v. Tellier*, 383 U.S. 687, 691 (1966).

losses.<sup>77</sup> Thus, our system strives to tax business income on a net basis.<sup>78</sup> By its most fundamental definition, therefore, the tax base is gross receipts minus deductions for the cost to generate those gross receipts.<sup>79</sup> There is no reason to suggest Congress is being any more “gracious” to taxpayers when it provides for deductions than it is being to the government when it provides for the inclusion of items of income. They are both part of the package that Congress defines as taxable income.<sup>80</sup>

The legislative grace principle also rests on the idea that, “grace” presupposing “power,” as a matter of legislative power Congress could deny all business deductions. This appeal to legislative *power* is, however, misplaced because *legislative intent, not power, is the issue*. In construing statutes, courts seek what Congress intended to do, not, except in limited cases, what it had power to do.<sup>81</sup> Congress has power to repeal the entire Tax Code but that implies nothing about how to interpret it. The issue in each case is whether Congress *intended* to permit a particular deduction, just as it would be whether Congress intended to require inclusion of something as income. If, however, we were going to explore the issue of power, we might conclude that deductions are not a matter of legislative grace at all. Removing all deductions from the Tax Code might be politically impossible, and, arguably, would violate the Sixteenth Amendment of the Constitution or the Due Process Clause of the Fifth Amendment.<sup>82</sup>

Imagine a tax on income without any deductions at a 30% tax rate. Suppose Grandma makes and sells homemade jam so that she can afford to live. She receives \$10/jar but it costs her \$2/jar to make it and \$6/jar to ship it. If she sells 1000 jars over the course of the year, could she get taxed on \$10,000 even though she only made \$2,000 for the entire year? At a 30% tax

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77. *Id.* (citing 50 Cong. Rec. 3849 (1913)); J.S. SEIDMAN, SEIDMAN'S LEGISLATIVE HISTORY OF FEDERAL INCOME TAX LAWS 962 (Prentice Hall 1953) (1938) (citing 55 CONG. REC. 3849 (1917)).

78. *Comm'r v. Tellier*, 383 U.S. 687, 691–92 (1966).

79. *Id.* at 693.

80. In the Revenue Act of 1954, Congress deleted the term “net income” and introduced the term “taxable income.” It is clear, however, that by using the term “taxable income” Congress did not intend to depart from the principle of taxing net income, rather than gross income. Grigsby & Coe, *supra* note 23, at 35–36.

81. See *United States v. Am. Trucking Ass'ns, Inc.*, 310 U.S. 534, 542–43 (1940).

82. *Taxability of Gross Income Under the Sixteenth Amendment*, 36 COLUM. L. REV. 274, 281, 283 (1936); *cf.* *Stewart Dry Goods Co. v. Lewis*, 294 U.S. 550, 562–63 (1935) (noting, “every taxing law must pass the constitutional test established by the courts to the method of imposition”).

404 *HOUSTON BUSINESS AND TAX LAW JOURNAL* [Vol. IV

rate she would have to pay more in taxes (\$3,000) than she made for the year (\$2,000). And if Congress ever attempted to create such a system—taking all deductions away from taxpayers like Grandma under the auspices of its “legislative grace”—we can be sure that the American People would swiftly remind those legislators that their tenure in office is a matter of “electorate grace.”<sup>83</sup>

We need not fully explore whether Congress has constitutional power to repeal all business deductions. It is sufficient to point out that significant constitutional issues would arise if Congress sought to do so and therefore the power of Congress to deal with deductions entirely as it pleases may be open to question.<sup>84</sup>

Therefore, the conclusory statement that deductions are a matter of legislative grace—that taxpayers are lucky to be getting any deductions at all, that only by the good grace and benevolence of our legislators are we entitled to any reductions to our gross income—seems unrealistic. Deductions are deeply and inextricably engrained in our income tax system; they are fundamental to it, and as long as an income tax continues in force, so will deductions. As a practical matter and perhaps as a constitutional matter, Congress may not have the power to change this.<sup>85</sup> The notion that deductions are a matter of legislative grace is, therefore, a *non sequitor*.

Indeed, a carte blanche presumption against deductions is unjustified, and its application represents an abnegation of one of the judiciary’s greatest and most legitimate functions: To ascertain as near as may be the meaning of legislative acts.<sup>86</sup> Provisions for deductions, capitalization, and the inclusion of items in income should be read simply as Congress wrote them. They deserve a reasonable construction—a construction that is neither narrower nor unduly broader than Congress defined. The courts should not resort to shorthand phrases to avoid the difficulty of ascertaining statutory meaning.<sup>87</sup> In this respect, the function of the courts should be to interpret what the statute fairly means.<sup>88</sup> No more, no less.

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83. A fancy way of saying the American People would kick them out of office.

84. See generally Lowy, *supra* note 73 (elaborating on the Constitutional argument).

85. *Id.*

86. Griswold, *supra* note 24, at 1143.

87. Grigsby & Coe, *supra* note 23.

88. Griswold, *supra* note 324, at 1146.



B. *Deductions are not an Exception to Capitalization*

Perhaps recognizing the fragility of this legislative grace doctrine, Associate Justice Harry Blackmun, in 1992, offered an alternative convention to support a presumption that deductions should be narrowly construed. He authored the theory that deductions are the exception to the norm of capitalization.

This rationale was first stated by the Supreme Court *INDOPCO, Inc. v. Comm'r*, 503 U.S. 79 (1992). It seems that Justice Blackmun, who delivered the opinion for the majority, recognized the infirmity on which was built the notion that deductions should be narrowly construed was built and, in keeping with his reputation for thoroughness he drafted a creative justification for this rule of construction.<sup>89</sup> The upshot: Justice Blackmun stated that deductions are the exception to the norm of capitalization and therefore they should be strictly construed.<sup>90</sup>

The argument Justice Blackmun advanced is basically that: The Internal Revenue Code, Section 263, sets up capitalization as the general rule—and this rule applies unless a specific exception is carved out. Such exceptions were carved out by Congress when it enumerated a specific list of deductions in sections 161-249. Thus, the specific list of deductions set forth in sections 161-249 is exceptions to the general rule established in section 263. Presumably, the significance of this is that exceptions are construed narrowly. That is, rules of statutory construction suggest that exceptions to the general rule, in this case deductions according to Justice Blackmun, are to be construed narrowly. There is no doubt that Justice Blackmun's reasoning is creative. There is an issue, however, whether the picture Justice Blackmun paints reflects reality and whether his reasoning is ultimately sound.

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89. One might also charge that his reasoning was in keeping with a reputation for result-oriented decision-making. It is significant that *INDOPCO* is just one of a collection of cases influenced by Justice Blackmun, all of which are pro-capitalization cases, perhaps by no-coincidence.

90. Note that Justice Blackmun drew the conclusion that deductions should be *strictly* construed. Although he said "strictly", the statement is understood—and perhaps fairly—to mean "narrowly". It would be hard to believe that Justice Blackmun's was pontificating about strict construction rather than lending support to the conventional, yet unsubstantiated, wisdom that deduction statutes should be read restrictively. Thus, by describing deductions as the exception to the norm of capitalization it is apparent that Justice Blackmun was implying something about the breadth of deductions generally and was not merely making the relatively unremarkable observation that statutory provisions should be read as they are written and should not be extended by judicial fiat.

## 406 HOUSTON BUSINESS AND TAX LAW JOURNAL [Vol. IV]

First, is capitalization set forth as a general rule? Well, Justice Blackmun contends that section 263 establishes the general rule of capitalization.<sup>91</sup> But section 263 is just one of at least 25 other Code sections that describe instances where capitalization is required.<sup>92</sup> For example, section 272 states very specifically that certain disposal costs of coal and domestic iron ore must be capitalized.<sup>93</sup> Section 280B states, very specifically, that certain costs of demolishing structures must be capitalized.<sup>94</sup> The point here is that the Code simply does not contain one general capitalization provision. Rather, it contains numerous capitalization provisions, some of which are quite specific.

Justice Blackmun also contends that all deductions are specifically enumerated.<sup>95</sup> Now, although some of the deductions delineated in the Code are specific, others are very broad, like section 162. In fact, section 162 is no more specific than section 263. Section 162 states the broad proposition that all business expenses are deductible (and then lists 3 non-exclusive examples of categories of expenses that fit within the general rule that business expenses are deductible).<sup>96</sup> By comparison, section 263 establishes two categories of expenses that are not immediately deductible (and then lists a number of expenses that are deductible even if they fall within either of the two categories of expenses for which a deduction is generally not permitted).<sup>97</sup> Thus, both sections establish broad categories of expenses that are or are not deductible. In a sense, they are both general, catchall type provisions, and there is nothing inherently characteristic about either of the sections that would suggest that section 162 is an exception to section 263.

Nor would the priority-ordering directive contained in Idaho Power add substance to the Court's position. According to the Idaho Power Court:

The priority-ordering directive of § 161—or, for that matter, § 261 of the Code—requires that the capitalization provision of § 263 (a) take precedence, on the facts here, over § 167 (a).

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91. Lowy, *supra* note 73.

92. *Id.*

93. I.R.C. § 272 (2000).

94. I.R.C. § 280B (2000).

95. Lowy, *supra* note 73.

96. I.R.C. § 162 (2000).

97. I.R.C. § 263 (2000).

Section 161 provides that deductions specified in Part VI of Subchapter B of the Income Tax Subtitle of the Code are “subject to the exceptions provided in part IX.” Part VI includes § 167 and Part IX includes § 263. The clear import of § 161 is that, with stated exceptions set forth either in § 263 itself or provided for elsewhere (as, for example, in § 404 relating to pension contributions), none of which is applicable here, an expenditure incurred in acquiring capital assets must be capitalized even when the expenditure otherwise might be deemed deductible under Part VI.<sup>98</sup>

This is consistent with the above theory. Exceptions always trump the general rule. But the fact that exceptions take precedence over general rules says nothing about whether the exception or the general rule should be interpreted narrowly.

In fact, as discussed in the preceding section, an analysis of the structure of the Code and where sections 162 and 263 fit in the overall goal of arriving at gross income suggests just the opposite, that capitalization is the exception to the general rule that expenses are deductible.<sup>99</sup>

## V. BROADLY CONSTRUING BUSINESS DEDUCTIONS

In addition to the reasons discussed above, the Code’s legislative history manifests a clear intent to paint business deductions with a broad brush. Section 162 has remained unchanged since the Revenue Act of 1918 and finds its origin in the Act of August 27, 1894.<sup>100</sup> In introducing the business deduction, Senator Vest of Missouri, who was in charge of the bill, stated that the word “business” was inserted in addition to the word “operating” expenses, “out of abundance of caution,” so that the deduction “would clearly cover all the legitimate expenses attending the business.”<sup>101</sup> And Senator Vest repeatedly asserted that the language of the bill was broad enough to cover various expenditures suggested by other senators.<sup>102</sup> Analyzing this legislative history, Dean Griswold concludes:

98. *Comm’r v. Idaho Power Co.*, 418, U.S. 1, 178 (1974).

99. Lowy, *supra* note 73.

100. Griswold, *supra* note 24, at 1145.

101. 26 CONG. REC. 6887 (1894).

102. *See* 26 CONG. REC. 6888, 7131, 7133 (1894).

The legislative history of those provisions gives clear evidence that they were intended to have broad application; and no action of Congress since that time has ever indicated a contrary intention. There would seem to be every reason why the words of the statute should be given a broad construction so as to achieve the obvious purpose of Congress to tax net business income.<sup>103</sup>

Moreover, construing narrowly provisions that provide for capitalization and construing broadly provisions that provide for deductions makes good sense from a policy perspective. Narrowly construing deductions would understate deductions, thus resulting in an overstatement of taxable income.<sup>104</sup> This could yield harsh results for taxpayers. Take Grandma from the illustration above, for instance. Disallowing deductions for her costs that are border-line between deductibility and non-deductibility could force Grandma to pay taxes on money she never made. That is, if she has net income of \$60,000, deductions that are very clearly business deductions of \$55,000, and border-line expenses (expenses that are legitimate costs of doing business but get shut-out by a narrow construction of section 162), Grandma will pay taxes on \$5,000 even though she is \$5,000 poorer at the end of the year. Such a result would be antithetical to the goals of our income tax system.

## VI. CONCLUSION

We should start with a presumption against presumptions. It is the function and duty of the courts to resolve statutory ambiguities by careful analysis of the language and other relevant indicia of legislative intent. Thus, unless there is good reason, courts should not resort to presumptions. There are, however, limited situations in which there are good reasons for a presumption. These include the two instances discussed above—the construction of business deductions and the construction of incentive tax credits. In contrast, instances that warrant the use of presumptions should not include a presumption to narrowly construe deductions. Such a presumption is without basis and fundamentally at odds with the structure of the Code and the underlying purpose of the income tax. Getting these

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103. Griswold, *supra* note 24, at 1145.

104. Grigsby & Coe, *supra* note 23.

2004]

*INTERPRETING TAX STATUTES*

409

presumptions correct is important. Misapplication of them can lead to injustice to taxpayers and can undermine the intent of Congress. There is no grace in that.