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Some Observations on the Interpretation of the Internal Revenue Code

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By ALAN GUNN

According to the author, a minor problem in partnership taxation provides a useful illustration of the problem of following the language of the Internal Revenue Code slavishly, without regard to context and history, even if a literal reading leads to absurd results. Alan Gunn is J. duPratt White Professor of Law at Cornell Law School, Ithaca, New York.

My wife tells me that I am undergoing a mid-life crisis. To prove this, she observes that until a few years ago I wore only plain white underwear, but that now I wear some with stripes, and even checks. According to a magazine article,[1] a sudden change from plain to colorful underwear is a recognized symptom of mid-life nuttiness. In a feeble effort at self-defense, I have pointed out that the only reason I have colored underwear is that my wife herself bought them for me as a birthday present. This, she insists, is no defense at all, because the magazine article listed *wearing* colored underwear, not *buying* it, as a symptom.

I hasten to note that the analysis described in the previous paragraph is an example of what passes for humor in my family. Any rational person would realize that the magazine's reference to "wearing" must be taken in context as including only wearing that reflects the wearer's own taste, and no one would take the magazine's "test" literally. But what of the language in a statute? Some commentators, who appear to be entirely serious, take the position that the language of the Internal Revenue Code must be followed slavishly, without regard to context and

[1]Unfortunately, this important scientific document has been mislaid, so I cannot cite it.

history, even if a literal reading leads to absurd results. A minor problem in partnership taxation provides a useful illustration of the problem itself and of two ways of going astray in dealing with it.[2]

Increase in Partner's Basis upon Contribution of Property to Partnership

Ordinarily, a partner recognizes no gain upon contributing property to a partnership.[3] There are, however, two exceptions. The first, which has been in the 1954 Code since its enactment, has to do with constructive cash distributions. Some partnership contributions of mortgaged property will result in constructive distributions, and these may cause the contributor to recognize gain (the details of the process are unimportant for purposes of this discussion).[4] The second exception deals with contributions to investment company partnerships: since 1976, a contributor of appreciated property to an investment company partnership has had to recognize the appreciation as gain.[5]

The question arises whether gain recognized by a partner upon the contribution of property to a partnership will be reflected by an increase in the partner's basis for his partnership interest. If we ignore the statute for the moment and think about what makes sense, the answer is clear. Gain recognized because of a constructive distribution associated with the contribution of encumbered property should not trigger an increase in basis, because increasing the basis will in most cases lead to the contributor's taxable income being less than his economic income by the amount of the increase.[6] In the case of gain recognized when appreciated property is contributed to an investment company partnership, however, an increase in the partner's basis for his partnership interest is needed to prevent double taxation. Everyone who has considered the matter in print agrees with these conclusions.[7]

Section 722: Congressional Intent v. Statutory Language

What does the statute say about increases in basis? From 1954 until 1976—a period in which the only gain recognized upon contributions to partnerships was gain from constructive distributions—the statute did not provide for basis increases. In 1976, when Congress made contributions of appreciated property to investment company partnerships taxable, Section 722 was amended to provide that the basis of a partner's interest in a partnership is increased by "the amount (if any) of gain recognized to the contributing partner" at the time of the contribution.

If violence was not to be done to fundamental principles of taxation, the reference in Section 722 to "gain recognized to the contributing partner" had to be read as being limited to gains recognized because appreciated property was contributed to an investment company partnership. The plausibility of this reading is enhanced by the legislative history of the basis-increase requirement, which was adopted as a "conforming amendment" when transfers of appreciated property to investment company partnerships were made taxable for the first time. Commentators agree that the drafters of the 1976 amendment to Section 722 intended to provide for basis increases only in cases involving contributions to investment company partnerships. One treatise, for example, calls this conclusion "logical and reasonable, if not inevitable," and concedes that there is "no good . . . reason" for the results that would be reached if basis increases under Section

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[2] Section 722(f) of the Tax Reform Act of 1984, H. R. 4170, 98th Cong., 2d Sess. (1984), has now resolved the partnership-taxation problem discussed in this article. But the more fundamental issue—whether the statute must always be read literally—remains.

[3] I. R. C. Sec. 721.

[4] Under I. R. C. Sec. 752, the partner is treated as having received a cash distribution in the amount by which his liabilities are reduced when the encumbered property is contributed. The amount of this constructive cash distribution first reduces the partner's basis for his partnership interest. I. R. C. Sec. 733. If the amount of the distribution exceeds the basis of the partner's interest "immediately before" the distribution, the excess is treated as a gain from the sale or exchange of the partner's interest in the partnership. I. R. C. Sec. 731(a).

[5] I. R. C. Sec. 721(b). The term "investment company partnership" is used here to mean a partnership that would be an investment company as defined in I. R. C. Sec. 751 if the partnership were a corporation.

[6] For examples illustrating this point, see 1 A. Willis, J. Pennell & P. Postlewaite, *Partnership Taxation* § 24.03 (3d ed. 1981), and Jones, "Increase in Basis May Still Be Available After Revenue Ruling 84-15," 62 TAXES—*The Tax Magazine* 515 (August, 1984).

[7] Ibid. A somewhat similar issue is whether the basis of contributed property should be increased by the amount of gain recognized. Increasing the basis of contributed property does not lead to an absurd result, even if the gain in question results from a constructive distribution. See Jones, supra note 6, at 519-20. However, the structure and history of the partnership provisions suggest very strongly that contributed property should receive a basis increase on account of a constructive distribution only if a Section 754 election is in effect. The 1984 amendments make this clear.

722 were applied across the board.[8] A recent article in this journal took a similar line.[9] Nevertheless, both of these authorities argue that the language of Section 722 (before its amendment in 1984) compelled a basis increase whenever the contributing partner recognized gain. The language of the statute, we are told, is "clear and unambiguous," and so, "logically," that language must be followed literally, despite the absurdity of the result.[10]

"Literal" Meaning.—Why should the "literal" meaning of a statute be followed if the result will be a perversion of the goals of the legislature that enacted the statute? In everyday life, that kind of wooden preference for words over common sense would be regarded as a symptom of serious mental incapacity. Let us suppose, for example, that one of the commentators, upon leaving his office to catch a plane for Hawaii, tells his secretary that he is expecting an important letter from the Internal Revenue Service and instructs her to send the letter on to his hotel in Hawaii as soon as it comes in. The letter arrives, and the secretary puts it in a new envelope, addressed to the commentator in Hawaii. Just as she is about to drop the letter down the mail chute, she learns that a sudden storm has closed the airport and that no flights will leave that day. Now the secretary, who knows that the commentator will return to the office before going to Hawaii, has a choice: She can follow the "clear and unambiguous" language of her instructions and mail the letter, or she can take account of the commentator's reason for telling her to mail the letter and hold it for him. What should she do? If she does mail the letter, will the commentator's annoyance be allayed by the secretary's telling him that his instructions were "clear and unambiguous" and that her actions were "logical"?

"Plain Meaning" Interpretations.—The problem boils down to this: Why do people think that a federal judge, in applying a statute, should exercise less judgment and intelligence than one would normally expect from one's secretary? The only answer suggested by the commentators is that our traditional assignment of responsibilities to legislatures and courts demands woodenness in applying "clear" legislation. One commentator, for example, invokes a "general rule of statutory interpretation" to the effect that "legislative history is to be examined only if the statutory language is unclear."[11] This is simply not true. In 1940, the Supreme Court held in *United States v. American Trucking Ass'ns*[12] that the purpose of the statute, not its "literal words," must be followed when the "plain meaning" leads to results that are absurd or "plainly at variance with the policy of the legislation as a whole." To be sure, one still finds appeals to "plain meaning" in the Supreme Court's tax opinions, but these appeals are always accompanied by attempts to show that the "plain meaning" interpretation corresponds to the policies underlying the statute in question.[13] There are no modern Supreme Court tax opinions—and very few, if any, from lower courts—in which the writer of the opinion concedes that the result for which he argues would be absurd and not intended by Congress, but nevertheless insists that the result is required by the "clear" language of the statute.[14] One has only to consider the liquidation-reincorporation cases,[15] for example, to appreciate how far removed our tax system is from one in which the Code is interpreted literally.

Underlying the insistence upon "plain meaning" interpretations at all costs may be a fear that some courts may substitute their own judgments about tax policy for those of the legislature if judges are allowed the slightest latitude in interpretation. This is a legitimate concern, but insistence that judges follow the words of the statute rather than the plain intention of Congress in cases in which these differ would be an unsatisfactory deterrent even if the courts could be persuaded to adopt it. The whole point of legislative supremacy is, after all, that the decisions of Congress should not be undermined by judges; the risk that courts may misread the

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[8] 1 A. Willis, J. Pennell & P. Postlewaite, supra note 6, at § 24.03.

[9] Jones, supra note 6, at 518-19.

[10] 1 A. Willis, J. Pennell & P. Postlewaite, supra note 6, at § 24.03; Jones, supra note 6, at 517-18. Mr. Jones is somewhat less insistent than the authors of the Willis book about the inevitability of the "plain meaning" interpretation; his principal argument seems to be that taxpayers would be justified in taking a "plain meaning" approach on their returns.

[11] 1 A. Willis, J. Pennell & P. Postlewaite, supra note 6, at § 24.03.

[12] 310 U. S. 534, 543, rehearing denied, 311 U. S. 724 (1940).

[13] See, e. g., *Badarocco v. Commissioner*, 84-1 USTC ¶ 9150, 104 S. Ct. 756 (1984).

[14] For an example of a court of appeals decision refusing to follow "plain language" on the ground that doing so would produce a result that no rational Congress could have intended, see *J. C. Penney Co. v. Commissioner*, 63-1 USTC ¶ 9129, 312 F. 2d 65 (CA-2) (Friendly, J.).

[15] E. g., *Reef Corp. v. Commissioner*, 66-2 USTC ¶ 9716, 368 F. 2d 125 (CA-5).

intentions of the legislature hardly justifies their ignoring those intentions when they are clear. Furthermore, if the courts were to begin giving the Code a "plain meaning" interpretation, Congress would constantly have to amend the Code to bring its precise language into line with its aims, and the inevitable result would be a tax statute even less comprehensible than the one we have now. (Readers who doubt this are invited to read a section—almost any section—of the British tax statute, which is, for the most part, interpreted quite literally by the British courts.)

Revenue Ruling 84-15

The IRS's response to the problem of basis increases upon contributions to partnerships was Revenue Ruling 84-15,[16] which reached the conclusion that basis should be increased under Section 722 only in cases of transfers to investment company partnerships. This, as noted above, is the only sensible result. Unfortunately, the IRS's explanation for its conclusion is at least as foolish as the "plain meaning" argument. It is hard to believe that the IRS had any reason for issuing Revenue Ruling 84-15 other than a conviction that Section 722 should be given a sensible, practical interpretation. One scans the text in vain for any acknowledgement of this, however, for nowhere in the ruling is there any discussion of the benefits of one interpretation over the other.[17] Instead, one finds metaphysics: gain recognized on account of a constructive distribution arising from the contribution of mortgaged property is, we are told, gain recognized "after" the contribution, rather than "at the time of" the contribution. Therefore, according to the IRS, the language of Section 722 precludes its application to gains other than those recognized when appreciated property is contributed to an investment partnership. The inanity of this argument becomes apparent when one tries to assign a specific period of time (10 seconds? 1/1000 of a second?)[18] to the gap between the contribution and the recognition of gain. There may be a touch of poetic justice in responding to a hyper-technical reading of the statute with an even more technical argument based on time differences between real contributions and imaginary (i. e., "constructive") distributions, but in the long run this kind of concept mongering will not further the cause of sensible interpretation. What was needed was a straightforward appeal to common sense, to the legislative purpose, and to our longstanding history of interpreting statutes to further their intended purposes.

Conclusion

The specific problem of basis adjustments associated with gains on contributing property to partnerships has now been resolved by statute: The Tax Reform Act of 1984 amended Section 722 (retroactively to 1976) to "clarify"[19] the inapplicability of the basis-increase rule to gains arising from constructive distributions. But no amount of drafting will make the Code interpretation-proof: similar problems have arisen and will continue to arise in other areas of taxation. It is curious that tax lawyers, who deal every day with the interpretation of statutes, should be so out of touch with modern views of legal interpretation. Over a hundred years ago, Christopher Columbus Langdell responded to an argument that a particular principle of contract law would lead to "unjust" and "absurd" results by calling the argument "irrelevant."[20] Today, Langdell's writings are used as models of how not to think about legal problems. That Langdellian arguments are still put forward by tax commentators does not reflect well upon the tax bar.[21] ●

[16] I. R. B. 1984-4, 8 (January 23, 1984).

[17] Although the ruling says nothing about the advantages of a nonliteral interpretation, it does cite the legislative history of Section 722.

[18] On the importance of being specific in discussing time, see Einstein, "Zur Elektrodynamik bewegter Körper," 17 *Annalen der Physik* 891 (1905).

[19] H. R. Rept. No. 98-861, 98th Cong., 2d Sess. at 1226 (1954) (Conference Committee Report).

[20] See L. Fuller & M. Eisenberg, *Basic Contract Law* 408-09 (4th ed. 1981), quoting C. Langdell, *Summary of the Law of Contracts* 15, 20-21 (2d ed. 1880).

[21] The fundamental point made by this article is far from new; my object in writing this has been to remind tax lawyers of something too easily forgotten. For earlier and more extensive work along the same lines, see Brown, "The Growing 'Common Law' of Taxation," 1961 *University of Southern California Tax Institute*, 1, and Eisenstein, "Some Iconoclastic Reflections on Tax Administration," 58 *Harvard Law Review* 477 (1945).