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Confronting Ambiguous Penalty Regs With the Rule of Lenity

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Lenity, the rule that ambiguities are construed against the government, can be applied against ambiguous regulations on grounds that can be defended under *Chevron* and *Auer*. Treasury has used intentional ambiguities to create a true strict liability penalty under section 4941 or the regulations. An enhanced lenity doctrine may be needed to prevent the same from occurring under the new economic substance statute.

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Introduction

Perhaps the oldest canon of statutory construction is that penal statute ambiguities are construed against the government and in favor of the individual.[1] Although it's infrequently applied today, the canon is the rule of lenity. Lenity once applied universally in tax matters,[2] but courts have not construed ambiguities in general tax statutes against the government since the 1930s.[3] While the Supreme Court held in 1959 that lenity can limit a civil tax penalty,[4] lenity today is primarily raised in criminal cases.[5] However, the Tax Court in two recent cases declined to impose civil penalties on lenity grounds,[6] and defendants in a pair of recent criminal tax cases did not get much help from the canon.[7] That chance juxtaposition, taxpayer civil victories and criminal defeats, highlights the possibility that in the future the courts will apply the canon more in civil penalty cases than criminal ones.

Rand v. Commissioner[8] refreshed lenity's importance in the civil penalty context. In this report, I speculate that some background issues in *Rand* could be as important as its use of lenity in statutory interpretation. The first issue is whether the Tax Court must defer to the government's interpretation of a penalty when Treasury or the IRS intentionally created, or opportunistically exploited, the ambiguity. The second issue concerns fears about ambiguities in the penalty for transactions lacking economic substance recently added to section 6662.

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[1]Amy Coney Barrett, "Substantive Canons and Faithful Agency," 90 *B.U. L. Rev.* 109 (2010).

[2]"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." *Gould v. Gould*, 245 U.S. 151, 153 (1917).

[3]*See* discussion in Peter A. Lowy and Juan F. Vasquez Jr., "Interpreting Tax Statutes: When Are Statutory Presumptions Justified?" 390 *Houston Business and Tax Law Journal* 389 (2004).

[4]"We are here concerned with a taxing act which imposes a penalty. The law is settled that 'penal statutes are to be strictly construed,' and that one 'is not to be subjected to a penalty unless the words of the statute plainly impose it.'" *Commissioner v. Acker*, 371 U.S. 87 at 91 (1959) (internal citations omitted).

[5]*See, e.g.*, Kristin E. Hickman, "Of Lenity, *Chevron*, and KPMG," 26 *Va. Tax Rev.* 905 (2006-2007). Hickman describes regulations with provisions parallel to a criminal statute as "hybrid," and notes that courts have applied lenity to hybrid regulations to avoid incongruent interpretation results. *Id.* at 921.

[6]*Rand v. Commissioner*, 141 T.C. No. 12 (2013); *Mohamed v. Commissioner*, T.C. Memo. 2013-255.

[7]*United States v. Williamson*, 746 F.3d 987 (10th Cir. 2014); *United States v. Kahre*, 737 F.3d 554 (9th Cir. 2013).

[8]*Rand*, 141 T.C. No. 12 (2013). *See also* Andrew R. Roberson and Roger J. Jones, "Lenity and Strict Construction — Overlooked Tools of Construction?" *Tax Notes*, Apr. 14, 2014, p. 247.

Rand involved section 6662, but that penalty was added after its relevant tax years. I suggest here that while the code does not clearly define economic substance, the real problem is the possibility that Treasury and the IRS will use rules and regs not to fill in gaps, but to exploit ambiguities for institutional ends. I analyze the section 4941 regs as an example of how dangerous that problem can be. The Tax Court has both the right and the responsibility to resist the offensive use of ambiguity. Further, Supreme Court authority on an agency's interpretive role contemplates judicial policing of it.

Chevron, *Mayo*, and *Auer*

Understanding *Rand*[9] begins with an appreciation of the facts. Yitzchok Rand and his then-wife Shulamis Klugman improperly claimed three refundable credits and received a refund of $7,327 based on fabricated income and false claims that they and their children resided in the United States.[10] Those are compelling facts for asserting a penalty. How did the IRS lose the case?

One cannot discuss statutory ambiguity without also discussing *Chevron U.S.A. Inc. v. Natural Res. Def. Council Inc.*[11] *Chevron* held that an administrative agency has a significant, often decisive, role in interpreting ambiguities in a statute that it administers. In *Mayo Foundation for Medical Education & Research v. United States*,[12] the Court removed any doubt that Treasury's regulatory interpretation of the code is entitled to *Chevron* deference. Many now fear[13] that *Mayo*'s underscoring of deference will result in code ambiguities being resolved against the taxpayer.

Regulations also can be ambiguous. The concern that *Mayo* may tip the balance of power too far in favor of the IRS is based in part on *Chevron*'s progeny, in particular, the *Auer v. Robbins*[14] line of cases. At the risk of oversimplifying it, *Auer* stands for two propositions. First, because an agency is the source of a regulation's text, its interpretation of that text ordinarily controls. Second, courts should defer to an agency's reading of its regulation even if the reading is presented for the first time in a litigation brief. While *Auer* fits within *Chevron*, the shift from construing ambiguities in a statute to construing ambiguities in a regulation is substantial. The Court foresaw the potential for abuse in the *Auer* rule and implicitly created limitations on its application.[15]

The IRS relied primarily on *Auer* in *Rand*.[16] To the IRS, *Rand* was a test vehicle to persuade the Tax Court that it was bound, under *Auer*, to accept the IRS's litigation position on an ambiguous regulation that addressed an ambiguous code section.[17] *Rand* distinguished *Auer* by finding the regulation in question to be silent on the relevant issue rather than ambiguous. But in an indication of concern over the IRS's aggressive deference argument, the *Rand* majority bolstered its holding by weighing the rule of lenity against *Chevron*.[18] It did not reach the question of how deference would apply if Treasury were to promulgate a regulation reversing the *Rand* holding.[19] That statement appears to be an indirect reference to *United States v. Home Concrete & Supply LLC*,[20] in which the Supreme Court invalidated regulations that Treasury promulgated, in reliance on the progeny of *Chevron*, to overrule some judicial decisions. Three judges dissented in *Rand* because, they wrote, the majority did not go far enough in rejecting the IRS's approach; they connected lenity to constitutional considerations as an even more robust bulwark against *Chevron* overreach. Tellingly, the two dissenting judges who thought taxpayers should lose did so exclusively on statutory construction grounds, making zero reference to the regulations or the IRS's reliance on *Auer*. A chillier reception of an asserted Supreme Court precedent is hard to imagine.[21]

Two factors might explain the strength of the *Rand* court's reaction. First, the Tax Court observed that the IRS chose not to proceed under alternative, unambiguous, and more narrowly tailored penalty code sections, a clear sign that strategic institutional considerations drove the IRS's prosecution selection and litigation posture. That is deeply troubling, for

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[9]*Rand*, 141 T.C. No. 12 (2013).

[10]*Rand*, 141 T.C. at 225.

[11]467 U.S. 837, 843 (1984).

[12]131 S. Ct. 704 (2011).

[13]*See* Steve R. Johnson, "Preserving Fairness in Tax Administration in the *Mayo* Era," 32 *Va. Tax Rev.* 269, 272, n.7.

[14]519 U.S. 452 (1997).

[15]*See Chase Bank USA NA v. McCoy*, 131 S. Ct. 871 (2011), and *infra* text accompanying note 49.

[16]*Rand*, 141 T.C. at 212.

[17]Section 6662 imposing a penalty for underpayment of a tax required to be shown on a return.

[18]While lenity might remove ambiguity in a statute and in that situation *Chevron* would not apply, Hickman notes at least one case when *Chevron* deference trumped lenity. Hickman, *supra* note 5, at 921 (referencing *Babbitt v. Sweet Home Chapter of Communities for a Greater Oregon*, 515 U.S. 687 (1995)).

[19]*Rand* 141 T.C. at 214, n.6.

[20]132 S. Ct. 1836 (2012).

[21]Treasury is now seeking a legislative fix to the problem it saw in *Rand*. *See* Joint Committee on Taxation, "Technical Explanation of the Tax Reform Act of 2014, a Discussion Draft of the Chairman of the House Committee on Ways and Means to Reform the Internal Revenue Code: Title VI — Tax Administration and Compliance," JCX-17-14 (Feb. 26, 2014) and text accompanying note 132 of the JCT report.

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it evinces an attitude that ambiguities are prosecutorial resources rather than administrative deficits that the IRS is required to eliminate evenhandedly. Moreover, the ambiguity involves a penal provision, and that creates unusually sharp temptations for an agency charged with enforcement responsibilities.

Second, the Tax Court may have foreseen battles over ambiguities in the new economic substance doctrine, and reminded the IRS of the court's responsibility to act as a check and balance. Lenity, after all, is a judicial tool for protecting individuals from governmental overreach. If my surmises are correct, lenity is precisely the right response to *Auer*, but that connection should be underscored, which requires a better understanding of the problem with administrative ambiguity.

New section 7701(o) defines economic substance, but uses terms such as "substantial purpose," "meaningful way," and "transaction" whose meanings have been litigated for decades. A Joint Committee on Taxation report dryly noted, "There is a lack of uniformity regarding the proper application of the economic substance doctrine,"[22] but observed that "the Secretary has general authority to prescribe rules and regulations necessary for the enforcement of the provision,"[23] precisely the type of delegated gap-filling that is the raison d'être for *Chevron* deference.

Is the vague statutory definition of economic substance the real problem? Congress has now spoken — the intent to manufacture a tax benefit is wrong and deserves a penalty.[24] Complaints that advisers cannot tell which acts the economic substance doctrine prohibits miss the mark. How does one justifiably complete the sentence "Yes, I intended to manufacture a tax benefit, but . . ."? In all but the most extraordinary cases, the taxpayer's primary motive for engaging in a highly structured and transparently artificial transaction is manifest.

Because of section 6664(c)(2),[25] the JCT report characterizes the penalty for lack of economic substance as a strict liability.[26] Commentators have generally followed suit,[27] but that label is flawed. A strict liability penalty is one in which the defendant's mental state is irrelevant. Motive, however, is a mental state. Because section 6662(b)(6) punishes acts performed with a wrong intent, or motive, it is less like a strict liability penalty than those portions of section 6662(b) that punish taxpayers for negligence or the actions of their hopefully unbiased appraisers. Arguably, section 6664(c)(2) merely amplifies what is implicit in defining a particular intent as a wrong. By definition, one cannot act in good faith with a wrong motive. A reasonable cause defense typically turns on events beyond a taxpayer's control or reliance on an expert's characterization of the transaction, neither of which has much bearing on actual intent. While determining intent will always be subjective and hence intrinsically imprecise, motive is routine grist for judicial mills.

The real problem is not the lack of a statutory definition for economic substance but that the IRS could use that vacuum as a hunting license. Congress has increasingly lost patience with abusive tax shelters, but encouraging the IRS to take a more antagonistic attitude toward taxpayers steps onto a slippery slope. I argue that at a minimum, judicial scrutiny must be applied when an agency's penal rules and regulations are ambiguous.

First, drafting ambiguous rules and regulations is to some degree shirking. There is a long, frustrating history of taxpayers misusing guidance, but still Treasury has the responsibility to provide it to them. Hedging guidance with ambiguity is the first step toward treating taxpayers as the enemy.

Second, an ambiguous rule operates, intentionally or not, as a form of resistance to judicial oversight. Once a rule is clearly stated, it can be measured against the governing statute on the one hand, and applied as a yardstick to the conduct of the agency on the other. Ambiguity may keep the agency's options open, but independence and freedom of action are dangerous paradigms for agency behavior.

Third, and by far the most serious, truly clever ambiguity can by misdirection and subtly false reasoning imperceptibly supplant the text of a statute with an agency's preferred alternative meaning. While of little import to practitioners outside a narrow field, the intentionally ambiguous section 4941 regulations[28] are a frightening example of

[22]JCT, "Technical Explanation of the Revenue Provisions of the 'Reconciliation Act of 2010,' as Amended, in Combination With the 'Patient Protection and Affordable Care Act,'" JCX-18-10, at 142-151 (Mar. 21, 2010).

[23]*Id.* at 155.

[24]Given *Cheek v. United States*, 498 U.S. 192 (1991), the test had to include an objective element, but the core component is the taxpayer's subjective intent. Congress understandably used the phrase "lacking economic substance" given the decades of cases wrestling with the concept, but I believe "intent to manufacture a tax benefit" captures the gist of the new standard.

[25]Section 6664(c)(2) provides that reasonable cause and good faith are not defenses to a penalty imposed on a transaction lacking economic substance.

[26]JCT, *supra* note 22, at 155.

[27]*See, e.g.*, Kathleen DeLaney Thomas, "The Case Against a Strict Liability Economic Substance Penalty," 13 *U. Pa. J. Bus. L.* 445 (2010-2011); Richard M. Lipton, "'Codification' of the Economic Substance Doctrine — Much Ado About Nothing?" 112 *J. Tax'n* 325 (June 2010).

[28]Section 4941 penalizes a donor or a foundation manager who self-deals with the assets of a private foundation.

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extreme agency overreach. Those regulations allow the IRS to penalize a taxpayer for the unforeseen and unpreventable act of an unrelated third person — true strict liability. I believe those shockingly offensive regulations came about because Treasury believed that the Tax Reform Act of 1969 gave it a hunting license — the same fear that now surrounds section 6662(b)(6).

Signals of Obscuration

The question in strict liability is whether one can be penalized if he has no reason to know of a material fact. If strict liability were a plausible interpretation of section 4941, Treasury would have addressed the element "reason to know" in a straightforward manner. Instead, there are at least four indicators that reg. section 53.4941(a)-1 intentionally obfuscates reason to know as an element of section 4941: (1) it distorts the black letter authority on which it was based; (2) it cross-references reg. section 53.4941(d)-2(c)(1), which similarly distorts the real case on which it was based; (3) a key statement is reduced to a cryptic, five-word phrase positioned in what is unmistakably the wrong context; and (4) instead of describing the elements of the offense, it apophatically[29] provides examples of what are not defenses.

First, Treasury drew the first paragraph of the section 4941 regulations from this classic example from the Restatement (Second) of Trusts:

> If the trustee purchases for the trust property in which he has an individual interest but is not liable for breach of trust because he did not know and had no reason to know that he was purchasing property in which he had such an interest, he is nevertheless accountable for any profit which he makes. Thus, if a trust company as trustee instructs a broker to purchase certain bonds and the broker places the order with a bank which purchases the bonds from the trustee's commercial department, the trustee is accountable for any profit which it makes on the sale, although it had no knowledge or reason to know that it was purchasing the bonds from itself. The trustee in such a case, however, is not liable for interest at the legal rate or for any loss resulting from the purchase, as he would be if he had known that he was purchasing from himself.[30]

As discussed below, absence of reason to know is essential to that illustration. Remove that element, as Treasury did in its version[31] of the same example, and the message turns 180 degrees and upside down.

Second, the genesis for the third sentence of reg. section 53.4941(d)-2(c)(1) was a real case in which a disqualified person lent money to a controlled corporation and then contributed the corporation's note, which later became worthless, to a foundation.[32] The disqualified person had actual knowledge of the material facts. Reg. section 53.4941(d)-2(c)(1), however, strips the facts down to the single act of a third party who transfers the note of a disqualified person to a foundation. Standing alone, reg. section 53.4941(d)-2(c)(1) does not expressly exclude reasonable ignorance as a defense to a penalty. In fact, the IRS in GCM 37731 defends the potentially "harsh" results produced by the regulation against what appears to be vigorous internal debate.[33] The disqualified person could pay off the note before it was contributed, an argument that assumes reason to know, if not actual knowledge. As will be discussed further below, however, the use of reg. section 53.4941(d)-2(c)(1) as a cross-reference in reg. section 53.4941(a)-1(a) simply does not permit that exculpatory reading.

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[29]Apophatic description proceeds by way of negation when a subject matter is considered ineffable. *See infra* text accompanying notes 39-40. The section 4941 regulations clearly adopt an apophatic style, and because that approach is used almost exclusively in theological circles, I wonder what that says about the draftsmens' views of their task.

[30]Restatement (Second) of Trusts, section 203 cmt. *c* (1959).

[31]Reg. section 53.4941(a)-1(a)(1) reads in material part:

> Section 4941(a)(1) of the Code imposes an excise tax on each act of self-dealing between a disqualified person (as defined in section 4946(a) and a private foundation. Except as provided in subparagraph (2) of this paragraph, this tax shall be imposed on a disqualified person even though he had no knowledge at the time of the act that such act constituted self-dealing. Notwithstanding the preceding two sentences, however, a transaction between a disqualified person and a private foundation will not constitute an act of self-dealing if: (i) The transaction is a purchase or sale of securities by a private foundation through a stockbroker where normal trading procedures on a stock exchange or recognized over-the-counter market are followed; (ii) Neither the buyer nor the seller of the securities nor the agent of either knows the identity of the other party involved; and (iii) The sale is made in the ordinary course of business, and does not involve a block of securities larger than the average daily trading volume of that stock over the previous 4 weeks. However, the preceding sentence shall not apply to a transaction involving a dealer who is a disqualified person acting as a principal or to a transaction which is an act of self-dealing pursuant to section 4941(d)(1)(B) and section 53.4941(d)-2(c)(1).

Subparagraph (2) states a special rule for governmental officials not relevant here.

[32]Treasury Department Report on Private Foundations, at 19, Example 6 (Feb. 2, 1965); *see also* GCM 37037 (Mar. 9, 1977) for attribution.

[33]GCM 37731 (Oct. 26, 1978) is a continuation of the subject of GCM 37037 written two years earlier.

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Third, the one oblique statement the regulation makes about reason to know is deceptively positioned. Section 4941 makes *scienter* an express element of the penalty for government officials and foundation managers alone. Paragraph (a) of reg. section 53.4941(a)-1, containing the regulation passage quoted at footnote 31, covers ordinary disqualified persons. Paragraph (b) is set apart to cover foundation managers. The first sentence of subparagraph (b)(3) begins, ''For purposes of section 4941, a person shall be considered to have participated in a transaction 'knowing' that it is an act of self-dealing only if,'' and continues to provide a detailed description of *scienter*. In section 4941, the word ''knowing'' is connected only to government officials and foundation managers, so the reader is prompted by the statute and the regulation to think that the discussion in reg. section 53.4941(a)-1(b)(3) does not apply to ordinary disqualified persons. The second, third, and fourth sentences of subparagraph (b)(3) provide that knowing does not mean having reason to know but that having reason to know may create an inference of actual knowledge. All three sentences are logical continuations of the discussion of *scienter*.

Despite the logical progression of reg. section 53.4941(a)-1(b)(3), the second sentence has an easily overlooked introductory phrase: ''For purposes of this part [a regulation reference], and Chapter 42 [a statutory reference].'' Without context or explanation, five words expand the scope of reference of just the second sentence of subparagraph (b)(3) to include the provisions of paragraph (a); the third and fourth sentences return to actual knowledge, which clearly cannot apply to paragraph (a). The five words create a well-hidden escape if courts on first impression reacted strongly against the assertion of strict liability. Note, however, that even if an eagle-eyed taxpayer caught that shift, paragraph (a) is worded so that the distinction only permits, but not requires, accepting a reasonable mistake of fact as a defense.

Finally, when defining a penalty, determining whether something is a reasonable mistake of fact is neither an obscure, off-tangent question that Treasury could not have foreseen, nor is it some inexpressibly ineffable concept. The regulation provides that the penalty can apply even if one does not know that an act is self-dealing, but Treasury intentionally removed the provision that addresses reason to know. Silence on reasonable mistake here is the dog that didn't bark.

No Statutory or Legislative History Support

Section 4941 uses contractual transactions as its controlling paradigm, a perspective that places self-dealing within the framework of an intentional act[34] — the same position the Restatement (Second) of Trusts takes toward breaches of the duty of loyalty. Under the most agency-favorable reading of *Chevron*, however, one might argue that the text of the statute does not address whether fault is a required element of the penalty. The several general counsel memoranda giving section 4941 a strict construction[35] rely on the same snippet of legislative history: that disqualified persons should be subject to the highest fiduciary standards.[36] If Congress had authorities such as the Restatement (Second) of Trusts in mind when referring to ''highest fiduciary standards,'' Treasury's reversal of the Restatement's position is troubling. Moreover, the memoranda fail to mention another JCT passage more relevant to the duty of care and reason to know:

> The first-level tax is imposed automatically, without regard to whether the violation was inadvertent. However, if the self-dealer is a disqualified person only because he is a government official then the tax on self-dealing is imposed only if he knowingly participated in the self-dealing.[37]

While the dictionary definition of inadvertent includes unintentional lack of care, the second sentence suggests that in context, inadvertent means without *scienter*. Congress may have intended for section 4941 to penalize negligent conduct, but that sentence is the primary evidence for that proposition. Further, if inadvertent is indeed taken to mean careless, that is some indication that Congress had fault in mind as a trigger for the penalty.

How Treasury Misused Restitution Principles

At first blush, the Restatement example quoted above may seem contradictory. The trustee breaches neither his duty of loyalty nor duty of care. Still, he has a payment obligation, but the obligation is not a sanction.

Those simple points incorporate a deep insight from the law of restitution. Certainly, wrongful acts can give rise to a restitution obligation. But there are a wide range of cases when even a negligent plaintiff

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[34] *See* Meyer, ''*Estate of Atkinson* — When Strict Liability in Tax Went Awry,'' *Tax Notes*, May 5, 2014, p. 597, at 598.

[35] GCMs 39770 (Dec. 23, 1988), 39741 (July 5, 1988), 38904 (Oct. 6, 1982), 39107 (Aug. 6, 1982), and 36217 (Mar. 28, 1975).

[36] Staff of the Joint Committee on Internal Revenue Taxation, ''General Explanation of the Tax Reform Act of 1969, H.R. 13270,'' 91st Congress, P.L. 91-172 (Dec. 3, 1970), at 31.

[37] *Id.* at 34.

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can recover in restitution from a blameless defendant.[38] In short, there is a distinction between transfer of ownership and transfer of possession. A mistaken loss of possession ordinarily does not convey ownership; property law provides that the owner's property rights continue and prevail over the rights of a mere possessor. Put simply, a duty to make restitution, or to correct in section 4941 parlance, responds to equitable and property law imperatives unrelated to punishment or deterrence. On the facts of the Restatement example, the restitution principle at stake is not the loss suffered by the trust but rather the unjust enrichment enjoyed by the trustee, but the analysis is essentially the same.

The correction regime of section 4941 enforces the congressional determination that if charitable property has been wrongly taken, it must be returned. The converse proposition — if charitable property must be returned, it was wrongly taken — cannot be validly deduced from the first. Still, that second proposition, which the Restatement expressly and properly rejects, appears to be at the heart of how Treasury twisted the Restatement illustration.

Fallacious reasoning can still be highly persuasive. Out of the vast literature on a trustee's duty of loyalty, Treasury cannily selected one of the vanishingly few illustrations when an obligation is created without regard to fault or agreement. The Restatement example draws the boundary between *fiduciary* principles, which the trustee did not breach, and *restitution* principles, which in fact created the obligation. Treasury wrenched from its restitution roots the innate sense that something needing a remedy occurred in the Restatement illustration and planted on that restitution-derived insight the false fiduciary label of self-dealing. Treasury then inseparably connected the label to the penalty.

Treasury might have applied the teachings of the Restatement position in several ways. Section 4941 should, and clearly can, penalize a failure to make restitution even if the obligation arose from excusable ignorance. If the mistake is recognized as one and is left unrectified, mere possession becomes an intentional claim of right that section 4941 penalizes. That approach would have respected the congressional intent, and the Restatement black letter rule, to enforce restoration of property without the anomaly of penalizing nonculpable behavior.

To link a penalty to a restitution obligation, Treasury needed to finesse the duty of care. The attractiveness of the Restatement illustration as an entry point for the Treasury's narrative is clear. Treasury could reasonably address security trading as an administratively necessary safe harbor. The need for a safe harbor is real; private foundations invest in securities. Coordinated trading with a disqualified person is the only real harm, however; Treasury should have given blanket protection to all accidentally simultaneous trades in the anonymous securities market, leaving "accidentally" to be determined by the traditional standard of a reasonable person.

Rather than rely on the traditional standard, however, Treasury applied a narrow limitation to its safe harbor: It does not apply if the disqualified person trades a large block. Almost as if securities trades are ultrahazardous activities, the intended negative implication of the safe harbor is that a penalty automatically applies if a disqualified person trades a large block at the same time as a foundation, no matter what the circumstances may be. Within the confines of the safe harbor, trading a large block of stock becomes a proxy for the prohibited act. The critical shift replaces a penalty on careless behavior with a penalty on some events, thus finessing the duty of care.

Recognizing that critical shift brings the rest of reg. section 53.4941(a)-1(a) into focus. The Restatement chose facts that illustrate general principles. By converting those facts into the core of a single safe harbor exception, Treasury creates the inference that general principles do not apply in the section 4941 context, an inference that harmonizes with the position that it is the event, and not the behavior, that is penalized.

The cross-reference to reg. section 53.4941(d)-2(c)(1) is another indication that Treasury hoped to eliminate excusable ignorance as a defense. Without explanation, the cross-reference makes the safe harbor unavailable to trades of debt instruments. GCM 37731 indicates that Treasury thought that the disqualified person's control over the enforcement of the note, either as borrower or lender, creates a continuing relationship that is more dangerous than other types of self-dealing, but that position has the distinct feel of post hoc rationalization in the face of internal criticism. From the perspective of a legitimate administrative safe harbor, foundations and disqualified persons invest in both debt and equity securities, and the need for protection is the same in both cases. Of course, once the creditor/debtor relationship is discovered, or even once there is reason to know that the relationship exists, the restitution duty to correct the situation applies and a section 4941 penalty can be imposed for behavior that breaches that duty. But Treasury wanted to create the mindset that section 4941 applies to events, not behavior. Only (1) within the paradigm that self-dealing is akin to an ultrahazardous activity, and (2) with the belief that debt instruments are more dangerous than equity, does a zero-tolerance exclusion

[38]Restatement (Third) of Restitution, section 1 cmt. *f* (2010).

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of debt instruments from a trading safe harbor make even the slightest sense. The cross-reference in reg. section 53.4941(a)-1(a) indicates that no amount of due diligence is sufficient to prevent a penalty in the event of an unknowing, simultaneous debt instrument trade. In light of that, GCM 37731's post hoc justification for the admittedly harsh result of reg. section 53.4941(d)-2(c)(1) on the grounds that the disqualified persons could arrange for the payment of the debt is simply disingenuous.

To review, the Restatement teaches that behavior caused by excusable ignorance is not self-dealing. The illustration necessarily requires facts that show that reasonable care could not have avoided the mistake of fact. While the mistake can give rise to a restitution obligation, the mistake is not penalized. In stark contrast, the regulations describe self-dealing as if it were an event, not behavior. They state that the event is self-dealing even if caused by ignorance, eliding both reason to know and duty of care. Treasury restricts to a single safe harbor the fact pattern that the Restatement uses as just one example of excusable ignorance. The safe harbor is then even further restricted to show that in some circumstances, no due diligence will suffice. Indisputably, Treasury intended to replace ''highest fiduciary standards'' with a no-fault standard by using cleverly deployed ambiguity.

Even before the IRS unveiled its no-fault interpretation of section 4941 in litigation, commentators remarked on the extraordinary ambiguity of the regulations. Shortly after Treasury promulgated the final section 4941 regulations, Alvin Geske's review of key issues demonstrated recognition that they primarily provide guidance in the form of exceptions to rules that remain unstated, leaving analysts little choice but to reason by way of inference.[39] The problem is especially acute in connection with questions of potential indirect self-dealing, such as whether a corporation jointly owned by a foundation and disqualified persons can pay dividends. In connection with that point, he remarked:

> It would seem to be impossible to play the game of negative inferences with these regulations. Negative inferences from the above-mentioned exception could be interpreted to mean that any other activity is impermissible. Negative inferences from exceptions that apply solely to the controlled organizations could, on the other hand, be used to indicate that there are no indirect self-dealing problems in such transactions. Neither result is proper.[40]

And yet, the regulations are drafted so that on prosecutorial issues such as defenses and the exact scope of exceptions, negative inferences are generally the only available guidance.

In light of the section 4941 regulations, practitioners should be less concerned about how sections 6662(b)(6) and 6664(c)(2) might limit their creativity, and more about the hardening of institutional attitudes on enforcement. The IRS took the public indignation with private foundations that led to the Tax Reform Act as an opportunity to ''slip its leash'' and replace the tools crafted by Congress with its own agenda. A similar response can be observed now with tax shelters. Despite her sympathy for the administrative problems presented by abusive tax shelters,[41] professor Kristin Hickman all but predicted a case like *Rand* in her warning that prosecutorial zealotry could produce a judicial backlash.[42] But the prediction runs both ways. Continued resistance to politically legitimate descriptions of wrong intent will only increase institutional incentives to produce more brutal weapons of the prosecution. The section 4941 regulations demonstrate that left unchecked, institutional bias can use clever ambiguity to create interpretations far more extreme than most practitioners realize.

Lenity and *Auer* Are Compatible

Auer has been criticized strictly on administrative law grounds without regard to the canon.[43] But *Auer* is most troubling when wielded in a penalty case such as *Rand*. As Hickman noted, deciding that an act should be punished makes a moral judgment that, as a matter of political legitimacy, should ordinarily be reserved to elected representatives.[44] Even more grave, however, is the problem that because Treasury can act as both legislator and prosecutor, it has a strong institutional bias to draft and interpret penalty regulations as weapons for squelching bothersome differences of opinion. The problems caused by tax shelters and other abuses can create administrative tunnel vision that sees ''flexible'' penalty provisions as a positive virtue, ignoring the tremendous social cost of adding to the

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[39]Geske, ''Indirect Self-Dealing and Foundation's for the Use or Benefit of Disqualified Persons,'' 12 *Hous. L. Rev.* 379 (1974).

[40]*Id.* at 400.

[41]Hickman, *supra* note 5, at 933.

[42]*Id.* at 942.

[43]For example, Johnson believes *Auer* should be abrogated in tax cases because of its potential for abuse (Johnson, *supra* note 13, at 313), even while acknowledging that the Supreme Court has reaffirmed its adherence to *Auer* three times in 2011 and 2012. *Id.* at 292, n.128. Johnson posits a hypothetical case in which Treasury intentionally drafts an ambiguous regulation and later adopts the interpretation that experience shows produces the most revenue, an illustration that makes no appeal to lenity. *Id.* at 297.

[44]Hickman, *supra* note 5, at 923.

common perception that tax law is too complex, confusing, and unfair to worry about compliance at the margins.

Unfortunately, lenity is simply a weak reed when deployed exclusively as a rule of statutory construction. The Ninth Circuit in the *Kahre* criminal case[45] stated the general rule that lenity is essentially a last resort in statutory construction, applied only after ''a court has seized every thing from which aid can be derived.''[46] Indeed, the Supreme Court has suggested that as a canon of construction, lenity ''provides little more than atmospherics.''[47] *Rand*'s statutory analysis gave no weight to the penal character of the statute, giving the impression that its subsequent lenity reference was just makeweight. Moreover, *Rand* walled off the entirety of *Chevron*'s policy considerations on the basis of a distinction between silence and ambiguity that is not entirely persuasive. Perversely, that distinction regrettably encourages the creation of vague and broadly worded regulations to create placeholders for subsequent backfilling under *Auer*.

Rand was a missed opportunity to hold that lenity ought to apply to penal regulations as well as to statutes. The *Rand* court also missed a chance to review the reasons for giving lenity substantial weight in interpreting ambiguous regulations. Unlike Congress, an agency acts as legislator, judge, and prosecutor when it promulgates, interprets, and enforces a regulation.[48] Agencies promulgate, interpret, and enforce regulations in a process whose parts are not hermetically sealed from each other.

Auer requires courts to consider the context in which agencies advance their interpretation. The Supreme Court in *Chase Bank USA NA v. McCoy*[49] discussed some of the factors determining whether *Auer* should apply. The primary test is whether the interpretation reflects the agency's fair and considered judgment as to what the regulation required. The relevant agencies in both *Auer* and *Chase Bank* gave their respective views in an amicus brief requested by the Supreme Court. Because the agencies were not parties in the litigation, there was little reason to think that their positions were a '''post hoc rationalization' taken as a litigation position.'' *Auer* deference also requires that the agency's position be consistent with its prior interpretation and enforcement, that the regulation is in fact ambiguous, and that the regulation does more than simply restate the statute. That Treasury is a party to any tax penalty case is the type of circumstance that the Supreme Court implicitly indicated is a reason not to grant *Auer* deference.

Rand could have moved the strategic considerations hovering in the background to the forefront of its analysis. Hard judicial scrutiny should have been invoked if Treasury proceeded under a penalty regulation that is at best ambiguous when an unambiguous, more clearly applicable code section provides for a penalty. Alternative triggers for hard scrutiny can be envisioned. In a looser approach, that scrutiny could be justified under faithful agency principles. In a stricter approach, an expanded notion of lenity would apply. Both strategies address only those regulations providing for, or directly involved with, penalties. Under either strategy, *Rand* would have expressly set aside the regulation, not because of a technicality that may not survive appellate scrutiny, but for prophylactic reasons that squarely address and answer *Chevron* policy concerns.

Under a faithful agency approach, the assumption is that Treasury faithfully acts as Congress's agent. The Tax Court would defer to regulations following *Chevron* precedents as they evolve. If, however, (1) a regulation is ambiguous or silent and (2) the position advanced by the IRS appears influenced less by fidelity to congressional intent than an institutional bias to make its administrative burden easier, the Tax Court would not apply *Chevron*, or at least *Auer*, deference.

Under a robust lenity approach, the Tax Court would withhold deference from all ambiguous or silent penalty regulations. While Treasury does have a *Chevron* role to play in the articulation and definition of penalties, the moral and legitimacy aspects of a penalty demand that Treasury's role be transparent and accountable to Congress. Ambiguity avoids accountability and vitiates one of the rationales for deference. Rather than make guesses about the degree to which institutional biases are involved, perhaps the courts should disregard all sufficiently ambiguous penal regulations and rely solely on statutory construction.

Had *Rand* taken that path, the court would have started with lenity to justify its refusal to grant *Auer* deference, and only then proceeded with the statutory construction, this time without the aid of lenity, when in truth it was not needed. Congress can intentionally generate ambiguities when it creates administrative agencies and then lets them resolve those ambiguities. While regulatory ambiguities

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[45] *United States v. Kahre*, 737 F.3d 554 (9th Cir. 2013).

[46] *Kahre*, 737 F.3d at 572.

[47] *Moskal v. United States*, 498 U.S. 103, 108 (1990).

[48] If as some commentators have argued, prosecutors have too much power even when they do not write or interpret the law, surely the addition of those powers should be troubling. *See* Glenn Harlan Reynolds, ''Ham Sandwich Nation: Due Process When Everything Is a Crime,'' 113 *Colum. L. Rev.* Sidebar 102 (2013), *available at* http://www.columbialawreview.org/ham-sandwich-nation_Reynolds.

[49] 131 S. Ct. 871.

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can arise from simple mistake or oversight, it is a fundamentally different matter for an agency to intentionally create ambiguities in its own regulations, or take advantage of a statutory ambiguity for its own institutional purposes. When the statute or regulation concerns a penalty, that agency conduct should be repugnant to general notions of justice.

As Amy Coney Barrett describes lenity, it ''was not grounded in any fiction about Parliament's presumed intent; rather, it was unabashedly grounded in a policy of tenderness for the accused. In fact, lenity is commonly acknowledged to have been a mechanism that English judges employed to counter the brutality of then-existing criminal law.''[50] Lenity's original role as a check on systemic injustice can be given new life in the tax realm on grounds that are fully compatible with *Auer* analysis.

[50]*See supra* note 1, at 129.

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