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THE COMMON KNOWLEDGE OF TAX ABUSE

Mark P. Gergen*

THE usual objection to the standards of tax motive and economic substance is that they lead to unprincipled decisions. Joseph Isenbergh lambasted decisions applying the standards as “an essentially aesthetic response to attempts by taxpayers thought unworthy of success . . . [and] unappealing.”¹ Judge McKee, dissenting in the court of appeals in *ACM Partnership v. Commissioner*,² accused the majority of using a “smell test” and chastised: “Our inquiry [ought to be] cerebral, not visceral. To the extent that the Commissioner is offended by these transactions, he should address Congress and/or the rulemaking process and not the courts.”³ Alan Gunn has said that “efforts to explain the results of tax cases . . . by reference to ‘tax avoidance’ are never satisfactory.”⁴ But behind these charges that the standards are unprincipled lie conflicting arguments. Isenbergh and McKee want officials to enforce tax rules as they are written; Gunn wants officials to make tax law more coherent and principled. An answer to the case in principle against the standards emerges from the conflict between these positions. The standards mediate between our desire that tax law be coherent and principled and our desire that it be rule-bound. Rather than being an abnegation of the rule of law, the standards are a product of a commitment to law by imperfect rules.

This point is understood, at some level, by many tax lawyers.⁵ Yet it is worth making. Still the argument is heard that the standards are lawless.⁶ It is worth reminding ourselves of the emptiness of this attack. On a more positive note, we learn something important about how the stan-

* I thank Calvin Johnson, Clarissa Potter, David Weisbach, and participants in the Georgetown Tax Policy Workshop for the comments on an earlier draft.

1. Joseph Isenbergh, *Musings on Form and Substance in Taxation*, 49 U. CHI. L. REV. 859, 874, 876 (1982).

2. 157 F.3d 231 (3d Cir. 1998), *aff'g in part, rev'g in part*, 73 T.C.M. (CCH) 2189 (1997), *cert. denied*, 526 U.S. 1017 (1999).

3. *Id.* at 265.

4. Alan Gunn, *Tax Avoidance*, 76 MICH. L. REV. 733 (1978).

5. See David P. Hariton, *Sorting Out the Tangle of Economic Substance*, 52 TAX LAW. 235, 236-241 (1999); Dana L. Trier, *Beyond the Smell Test: The Role of Substantive Anti-Avoidance Rules in Addressing the Corporate Tax Shelter Problem*, TAXES, Mar. 2000, at 62, 67.

6. See Kenneth J. Kies, *Letter to the Editor*, 88 TAX NOTES 133 (2000); Kenneth W. Gideon, *Assessing the Income Tax: Transparency, Simplicity, Fairness*, 81 TAX NOTES 999 (1998).

dards ought to be applied. That an action was tax motivated or insubstantial is neither a necessary nor sufficient reason to deny it positive tax consequences. There is always and finally a question of tax law, albeit a question that sometimes will turn on implicit norms of tax law or on the common knowledge of tax professionals.⁷ We better appreciate recent anti-abuse regulations and rulings, in particular the partnership anti-abuse regulations.⁸ These regulations posit norms of tax law that cannot be violated intentionally but that can be violated inadvertently in the sense that their violation can be a by-product of actions that themselves are not tax-motivated and have economic substance. These anti-abuse rules deter taxpayers from purposefully exploiting simplifying tax rules that we know miscalculate income but which we generally tolerate for reasons of administrative efficiency.⁹

This explanation of anti-abuse law is conducive to David Weisbach's economic argument for why we might want to have simple rules of tax law that are backstopped by anti-abuse standards.¹⁰ Weisbach's work, like almost all academic work on tax law today, takes an external to law perspective—his claims are *about* tax law, they are not claims *of* tax law. That an external to law, economic perspective can justify the anti-abuse standards is not surprising, for this perspective places no intrinsic value on the law being transparent and non-arbitrary. There is a deep irony here. The external to law perspective dismisses tax law as an object worthy of study and reflection in its own right, but the success of anti-abuse standards depends upon players in the system believing in the integrity of tax law.

The standards of tax motive and economic substance are used to determine when a taxpayer may not have a positive result under a tax rule even though he has complied literally with the terms of the rule. The standard of tax motive, in its purest form, is something like the precept "No *X* if *A* is done solely for tax reasons,"¹¹ where *X* is a positive tax result that follows from act *A* under some rule of tax law. The converse form is "No *X* unless *A* is done for a substantial business purpose."¹² The

7. See *infra* notes 11-32, 75-77 and accompanying text. There is one unfortunate consequence of recognizing the implicit issue of law. Decisions of the tax court would then be subject to de novo review by courts of appeals. See *ACM*, 157 F.3d at 245.

8. See Treas. Reg. § 1.701-2 (2000).

9. See *infra* notes 64-65 and accompanying text.

10. See David A. Weisbach, *Formalism in the Tax Law*, 66 U. CHI. L. REV. 860, 867-72 (1999) [hereinafter *Formalism in Tax Law*]; see also Daniel N. Shaviro, *Economic Substance, Corporate Tax Shelters, and the Compaq Case*, 88 TAX NOTES 221 (2000); David A. Weisbach, *An Efficiency Analysis of Line Drawing in the Tax Law*, 29 S. LEGAL STUDIES 71 (2000) [hereinafter *Line Drawing in the Tax Law*]; DAVID A. WEISBACH, AN ECONOMIC ANALYSIS OF ANTI-TAX AVOIDANCE DOCTRINES (Univ. of Chicago Law Sch., John M. Olin Law & Econ. Working Paper No. 99, 2000) available at <<http://www.law.uchicago.edu/Publications/Working/>> [hereinafter *ECONOMIC ANALYSIS*].

11. See Preliminary Senate Finance Committee Discussion Draft Regarding Corporate Tax Shelters (May 24, 2000) (proposing as a test for a corporate tax shelter "that a significant purpose of such arrangement is the avoidance or evasion of Federal income tax"); see also Gunn, *supra* note 4, at 737-38 (providing a collection of cases).

12. See *Helvering v. Gregory*, 69 F.2d 809 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935).

standard of economic substance is something like the precept “No *X* if *A* is not expected to meaningfully alter the taxpayer’s position, tax considerations to the side.”¹³ Another form of the precept, different in a key respect,¹⁴ is “No *X* if *A* is expected to worsen the taxpayer’s position tax considerations to the side.”¹⁵ These standards are well established in the law. They have been invoked by judges in a line of cases that run from *Gregory*,¹⁶ through *Knetsch*,¹⁷ to *ACM*.¹⁸ They appear in the Code,¹⁹ in the Regulations,²⁰ and they have been invoked by the Treasury in anti-abuse rulings.²¹ Sometimes the standards are qualified by objective elements that serve as proxies for tax motives and economic substance.²²

13. I strongly recommend David P. Hariton, *Sorting Out the Tangle of Economic Substance*, 52 *TAX LAW* 235 (1999), for a more thorough analysis of this standard. The rule in text is a translation of the standard stated in *Knetsch v. United States*, 364 U.S. 361, 366 (1960), that the “transaction . . . did ‘not appreciably affect his beneficial interest except to reduce his tax . . .’” (quoting dissenting opinion in *Gilbert v. Commissioner*, 248 F.2d 399, 411 (2d Cir. 1957)). The general partnership anti-abuse regulation set forth in Treas. Reg. § 1.701-2(a)(1) requires that a transaction “be entered into for a substantial business purpose.” *Id.* And Treas. Reg. § 1.701-2(b) permits the Commissioner to recast “a transaction a principal purpose of which is to reduce substantially the present value of the partners’ aggregate federal tax liability . . .” *Id.* The later rule is instantiated by “a comparison of the purported business purpose for a transaction and the claimed tax benefits resulting from the transaction.” Treas. Reg. § 1.701-2(c).

14. One way to express the difference is that the first rule stated in text gets at the quality of emptiness while the second rule gets at the quality of irrationality. A sham divorce is empty if one assumes nothing untoward might happen before the couple remarries. If there is a risk of an untoward event, such as one partner dying, a sham divorce is irrational, tax considerations to the side. An action is both empty and irrational when it is done at a positive transaction cost but is otherwise devoid of significance.

15. Alvin C. Warren, Jr., *The Requirement of Economic Profit in Tax Motivated Transactions*, *TAXES*, Dec. 1981, at 986-88 (discussing *Knetsch* and *Goldstein v. Commissioner*, 364 F.2d 734 (2d Cir. 1966)). This standard was rejected by a majority of the Tax Court in *Stanton v. Commission*, CCH Tax Ct. Rptr. 2313 (1960). In determining whether an action is irrational the action is compared not just to the alternative of inaction. An action is compared to other actions that would accomplish the same non-tax objectives. So it was no defense of the complex transaction in *ACM* that it had the real business end of retiring the taxpayer’s debt because there were cheaper ways to achieve this end.

16. 69 F.2d at 809.

17. 364 U.S. at 366.

18. 157 F.3d at 231.

19. I.R.C. §§ 269, 7701(f) (2000). Proposed legislation on corporate tax shelters target any arrangement if “a significant purpose is the avoidance or evasion of Federal income tax.” Preliminary Senate Finance Committee Discussion Draft Regarding Corporate Tax Shelter Legislation (May 24, 2000), proposed I.R.C. § 6662A(c)(1)(A). Objective criteria define arrangements that are deemed to run afoul of this standard. These include profits insignificant relative to tax benefits, I.R.C. § 6662(A)(c)(2)(B); the allocation of taxable income or gain to a “tax-indifferent party” in excess of economic income that redounds to the tax benefit of the corporation, I.R.C. § 6662(A)(c)(2)(C); or significant tax benefits coupled with a tax indemnity, a permanent discrepancy between tax and book income, or little economic risk, I.R.C. § 6662(A)(c)(2)(D).

20. See Treas. Reg. § 1.701-2.

21. Typically these announcements invoke numerous tax avoidance doctrines and statutes making the best rationale difficult to discern. See Rev. Rul. 99-14, 1999-13 I.R.B. 3; I.R.S. Notice 99-59, 1999-52 I.R.B. 761; I.R.S. Notice 99-36, 1999-26 I.R.C. 3.

22. An objective element can magnify one of the worrisome properties of anti-abuse rules. At the margin, such rules heighten the deadweight loss from opportunistic tax planning because taxpayers set upon achieving a proscribed tax benefit will alter their behavior to bring themselves within the rule. This phenomenon is identified in Shaviro, *supra* note

Thus, under a discredited version of the step transaction doctrine, passing through point B on the way from point A to point C will be disregarded only if there was a pre-commitment to continue through point B to point C.²³ The element of pre-commitment establishes that point B was tax motivated and insubstantial. A rule presuming economic substance in a position if it is held for a sufficient length of time functions in the same way.²⁴

The sham divorce cases are a homey example of the standards at work.²⁵ The marital status of taxpayers is determined on the last day of the year.²⁶ Married couples, who would pay less in taxes if they file single returns, have tried to file as singles by divorcing at the end of the year and remarrying at the beginning of the next. The courts deny the taxpayers single status. There is some debate about whether this result depends upon the divorce being legally ineffective for non-tax purposes. *Goldstein v. Commissioner*²⁷ shows that the divorce be a sham in the literal sense is not essential to the result. Mrs. Goldstein made real contracts with different parties, borrowing at 4% while investing at 1% or 1.5%, to shelter her winnings from the Irish Sweepstakes. The realness of the contracts did not establish them as bona fide for tax purposes.²⁸

I put to the side arguments aimed solely at the subjectivity of the standard of tax motive and the converse standard of absence of business purpose.²⁹ A standard of motive or purpose has been criticized on the ground that it is not administrable. An actor's true motive, it is said, is unknowable, and apparent motive is too easily feigned.³⁰ The standard also has been criticized on grounds of fairness. It is unfair, the argument

10, at 221, and *Line Drawing in the Tax Law*, *supra* note 10, at 76-79, 82-83, 86. For example, a taxpayer who is set upon the stratagem of using a partnership to eventually dispose of property without recognizing gain will incur the extra cost and inconvenience of maintaining an interest in the property through a partnership with the buyer for a period of two years to avoid one of the critical shoals of the disguised sale rules. The same phenomenon occurs even without formal and explicit safe-harbors and shoals in anti-abuse law because officials and tax planners will use unwritten rules of thumb to decide what is abusive and what is not.

23. On the three different versions of the step-transaction doctrine, see *McDonald's Restaurants, Inc. v. Commissioner*, 688 F.2d 520, 524-25 (7th Cir. 1982). For statements that the binding commitment test is no longer applied, see *Associated Wholesale Grocers v. United States*, 927 F.2d 1517, 1522 (10th Cir. 1991); Joshua D. Rosenberg, *Tax Avoidance and Income Measurement*, 87 MICH. L. REV. 365, 404 (1988).

24. For an example, see the disguised sale regulations, Treas. Reg. § 1.707-3(c) (providing that transfers made more than two years apart are presumed not to be a sale and need not be disclosed to IRS).

25. See *Boyter v. Commissioner*, 74 T.C. 989 (1980), *remanded*, 668 F.2d 1382 (4th Cir. 1981); Rev. Rul. 76-255, 1976-1 C.B. 281.

26. See Treas. Regs. §§ 1-143-1(a) and 1.6013-4(a).

27. 364 F.2d 734 (2d Cir. 1966), *cert. denied*, 385 U.S. 1005 (1967).

28. See *id.*

29. Walter J. Blum, *Motive, Intent, and Purpose in Federal Income Taxation*, 34 U. CHI. L. REV. 485 (1967).

30. To this one might answer all the more reason to put great weight on evidence of tax motive when it exists, as the court did in *Saba Partnership v. Commissioner*, 78 T.C.M. (CCH) 684, 711-12 (1999) (discussing in-house memorandum explaining tax benefits of transaction).

goes, to treat two people in the same position differently because they had different motives in reaching that position.³¹ Whatever one's view of the merits of a subjective standard standing alone, when paired with the objective standard of economic substance, it serves the important function of signaling to officials that they are not to second guess business or personal judgments that do not seem tax-driven. The objective standard of economic substance is not a requirement that an action be reasonable to have tax consequences. Thus, in a case of an alleged sham divorce, if the couple can persuade the court that they foolishly got divorced after a holiday spat and changed their mind in the sober light of the new year, the divorce should be recognized in the eyes of tax law.

One other objection to the standards can be put to the side. Judge McKee's argument in *ACM* that the Commissioner should look to Congress and not to the courts suggests that he thinks the principle of legislative supremacy is at stake.³² This particular argument is frivolous at this level of generality.³³ The courts and the Treasury have long played a significant role in making tax law, with Congress' acquiescence. Transactions that run afoul of the standards of tax motive and economic substance usually exploit technical details of tax law on which Congress says little and probably cares less. Thus, the transaction in *ACM* took advantage of the combination of two highly technical tax rules to produce an artificial capital loss. One rule was statutory in the partnership area and the other was regulatory in the area of contingent debt.³⁴ In any event, Judge McKee conceded the Commissioner's lawmaking power when he indicated that the Commissioner could use the rulemaking process to address the transaction in *ACM*. The concern for legislative supremacy cannot explain a preference for executive action by rule-making rather than by litigation. If anything, the litigation route presents less threat of intrusion because it requires the complicity of the third branch.

31. This argument turns on the assumption that actors who do the same thing for different reasons are similarly situated. This does not hold up as a general proposition. The law often takes account of motive in evaluating actions. This is commonplace in criminal law and tort law. The argument is that tax law is different because tax is a function of an actor's income, i.e., his economic position. See Blum, *supra* note 29. But we know that tax law imperfectly measures income, often for administrative reasons. I have yet to hear a cogent argument why it is unfair to treat an actor who consciously tries to exploit the law's imperfections to understate his income differently than an actor who inadvertently benefits from these imperfections.

32. See *ACM*, 157 F.3d at 265.

33. The argument is not frivolous when Congress has responded to the specific problem. Corporate-owned life insurance (COLI) raises the issue. The tax court denied a corporation an interest deduction on leveraged life insurance because there was no prospect of economic profit in *Winn Dixie Stores, Inc. v. Commissioner*, 113 T.C. 254 (1999). Dana Trier plausibly objects that the law permits precisely this sort of interest-arbitrage in leveraged insurance within specified limitations, which the taxpayer met. See Trier, *supra* note 5, at 80-83.

34. The statutory rules were I.R.C. §§ 734(b) and 754, which make basis adjustments upon partnership distributions elective. The regulatory rule was a rule in the old contingent payment debt instrument regulations allowing a taxpayer to elect ratable basis recovery. See Temp. Treas. Reg. § 15a.453-1(c).

This shows that the principle at stake has to do with respect for the rule of law rather than legislative supremacy. Isenbergh's description of the decision in *Gregory* as "intuitive" and Judge McKee's description of the decision in *ACM* as "visceral" not "cerebral" bring to mind a concern for what Lon Fuller called the demands of the "inner morality of law"—"make the law known, make it coherent and clear, see that your decisions as an official are guided by it, etc."³⁵

The objection, in other words, is that these decisions are arbitrary and non-transparent. They seem so because the outcome does not follow from the standards. This is for the simple and often-noted reason that not every tax motivated and insubstantial action will fail of its intended tax purpose.³⁶ There is likely to be a tax motive whenever a well-advised taxpayer makes a gift of appreciated property to a charity or buys insurance with an investment component, or whenever a corporation invests in preferred stock. Further, these actions are dubious substantively in the sense that other actions would better serve the taxpayer's non-tax goals. The charity would prefer to receive cash, investment via insurance tends to have a lower pre-tax yield, and preferred stock has a lower pre-tax yield than comparable interest-bearing securities. While these examples might be shrugged off as academic (as I said, no tax lawyer would think them abusive), the problem is not so easily dismissed. The standards of tax motive and economic substance cast a pall over some day-to-day tax planning. Consider the question whether conversion of a limited liability company into a corporation will qualify it for a tax free merger. There is likely to be no non-tax reason to convert the company and the action has little substantive effect. But these are not decisive. I expect most tax lawyers would opine that the conversion would stand up to scrutiny though the cautious would advise that the company be run as a corporation for a decent interval before the acquisition. But no one knows for sure whether or how much such window-dressing is necessary.³⁷

But application of the standards is not arbitrary in the sense of being random. Good tax lawyers know when they are pushing hard at the edge of the envelope. True, in some cases, like the last example, the outcome is up in the air. Similarly, it was not foreordained that the taxpayer in *Gregory* would lose, or that the banks would win in *Cottage Savings Asso-*

35. LON L. FULLER, *THE MORALITY OF LAW* 42 (2d ed. 1969).

36. For a particularly cogent statement, see Gunn, *supra* note 4, at 745-46. See also Walter J. Blum, *Knetsch v. United States: A Pronouncement on Tax Avoidance*, SUP. CT. REV. 135, 146-47, 156 (1961).

37. Rev. Rul. 70-140, 1970-1 C.B. 73, applies the step transaction doctrine to hold that a transfer of assets to a corporation immediately prior to acquisition of that corporation by another corporation does not qualify under section 351. Compare *Weikel v. Comm'r*, 51 T.C.M. (CCH) 432 (1986) (refusing to apply step transaction doctrine where several months passed between transfer of patent to corporation and stock-for-stock exchange and acquisition had not been finalized at time of the transfer) and *West Coast Mktg. Corp. v. Comm'r*, 46 T.C. 32 (1966) (applying step transaction doctrine where taxpayer transferred land to corporation as part of pre-arranged plan in which the corporation was acquired for stock and immediately liquidated by the acquirer).

ciation v. Commissioner,³⁸ when they swapped equivalent loan portfolios to take advantage of a tax loss. It is no coincidence that these are all realization cases, an issue on which tax law is especially soft. But standards and fuzzy concepts generally are always unpredictable at the margin. Isenbergh recognized that tax lawyers do a pretty good job of distinguishing the good from the bad.³⁹ He argued this was shameful. To the question “who ultimately benefits from this approach?,” he answered “the tax bar,” observing “[t]he development of an exquisite set of intuitions about what kinds of transactions the courts ‘like’ and ‘don’t like’ has become a large part of what tax lawyers sell.”⁴⁰ But this particular argument misses the mark. Whatever one thinks about the merits of enriching tax lawyers, it is odd to blame anti-abuse law. It is the complexity of tax law that makes its mastery valuable. Mastery of its rules would probably be even more valuable in a world where artful plans always succeeded.⁴¹

We are left with the complaint that the standards are non-transparent or opaque. When I say that the standards are opaque, I mean that they do not explain the decisions. This quality of opaqueness is worrisome because it can lead to bad outcomes and bad analysis. Bad outcomes can occur when officials take the standards at their word. *Commissioner v. Court Holding Co.*⁴² illustrates one type of bad outcome. The taxpayer, a corporation, had already negotiated a sale of appreciated property when its tax advisors recommended that the corporation liquidate and distribute the property to its shareholders who would go through with the sale. At the time, a corporation did not recognize gain on a distribution of property. The liquidation was held a sham. What is troubling about the decision is that had the transaction always been planned as a liquidation followed by a sale, there would have been no corporate level tax.⁴³ On the same reasoning, it would be abusive for a person, who decided to sell appreciated stock and make a gift of the proceeds to charity, to

38. 499 U.S. 554 (1991).

39. For similar testimonials, see Trier, *supra* note 5, at 84 (stating “[It] appears difficult to conclude that the courts have exercised their discretion recklessly . . . the taxpayers and their counsel entering into the Merrill Lynch transactions had to know that economic substance was going to be placed in issue”); Lewis R. Steinberg, *Form, Substance and Directionality in Subchapter C*, 52 TAX LAW. 457 (1999) (claiming “it is averred [by others that] practitioners possess highly-developed intuitive powers for divining the economic substance of any transaction and applying the relevant tax principles and rules in accordance with that substance”).

40. Isenbergh, *supra* note 1, at 883.

41. Dana Trier has suggested that the standards might be considered unfair because similarly situated taxpayers, meaning, I gather, taxpayers who engage in similarly aggressive tax planning, are treated differently. See Trier, *supra* note 5. This sort of inequality is commonplace when the law is under-enforced.

42. 324 U.S. 331 (1945). This observation is inspired by Isenbergh, *supra* note 1, at 871-74, who offers alternative readings of the case. One reading is that the sale was completed before the dividend strategy was devised. Were this true, the case could be decided on assignment of income grounds.

43. This was not conclusively established until a few years later in *United States v. Cumberland Public Service Co.*, 338 U.S. 451 (1950).

change plans and give the stock to charity on the advice of his accountant. A great deal that is bad and little that is good can be said about treating actors differently depending upon when they obtain tax advice.⁴⁴ A related mistake is made by judges who submit the question of whether a transaction is abusive to a jury on an instruction that it must be found so if there is a tax motive and no economic substance.⁴⁵ These mistakes are related in that both follow from the mistaken assumption that tax motive and insubstantiality suffice to make an action abusive. Alan Gunn discusses a case involving the opposite sort of mistake in which a court ruled for the taxpayer once it found that the transaction was not tax motivated and had substance without considering other strong arguments against the taxpayer's position.⁴⁶ The mistake was to assume that the standards suffice to distinguish valid tax positions from invalid ones.

The standards lead to bad analysis to the extent they deflect officials from formulating and stating a valid reasoned explanation for a decision. This is the heart of Alan Gunn's objection to the standard of tax motive. His argument is that instead of relying on the standards of tax motive and insubstantiality in cases like *Gregory*, *Knetsch*, and *Goldstein*, the courts could have reached the same results by drawing on general principles of tax law.⁴⁷ Perhaps this was also Judge Learned Hand's point when he described the rhetoric of form and substance as "anodynes for the pains of reasoning."⁴⁸

The problems of bad outcomes and bad analysis are, to some degree, separable. We could reduce the incidence of bad outcomes of the types in the examples by adding the following disclaimer to the standards of tax motive and economic substance:

A determination that an action is tax motivated or insubstantial is neither a necessary nor a sufficient condition for denying a positive tax result to which the actor claims he is entitled under tax law. There may be other grounds for rejecting the actor's position. These standards do not displace other forms of reasoning. Further, some tax motivated or insubstantial actions are respected. As for which are respected and which are not, that is difficult to say. Do not always expect to find a rule or principle to sort them out. In a novel case the best guide may well be professional common knowledge.

This disclaimer makes it clear that the decision about whether an action is abusive should not, in the end, be put to the jury. While a jury might

44. See Marvin A. Chirelstein, *Learned Hand's Contribution to the Law of Tax Avoidance*, 77 *YALE L.J.* 440, 456-57 (1967) (stating that "this approach led to absurdities in practice").

45. See *United States v. Wexler*, 31 F.3d 117 (3d Cir. 1994). For a thoughtful discussion of the instruction, see Hariton, *supra* note 5, at 258-60.

46. See Gunn, *supra* note 4, at 756-57. The case is *Breech v. United States*, 439 F.2d 409 (9th Cir. 1971).

47. See Gunn, *supra* note 4.

48. *Comm'r v. Sansome*, 60 F.2d 931, 933 (2d Cir. 1932). The statement is cryptic in context because Hand makes it in extolling the statutory definition of reorganization, which he borrows to determine whether earnings and profits carry-over in a reorganization.

make preliminary findings on the factual issues of motive and economic effect, whether an action that is tax motivated or insubstantial is abusive is, finally, a question requiring the expertise of a tax professional. The disclaimer also makes clear the error in the case Gunn discusses where the court halted analysis after finding that an action was not tax motivated and had substance. And it would give the taxpayer in *Court Holding* a fighting chance.

While adding such a disclaimer to the standards reduces the risk of bad decisions, there remains the objection that the standards invite unsatisfactory analysis by allowing officials to rely on unstated reasons. This brings us close to the heart of the matter. To insist that officials formulate a reasoned, principled basis for a decision improves the quality of a decision only if we want tax law to be made principled by the officials who administer it. I use the phrase “to be made principled” because tax law is not naturally or intrinsically principled. If there is a deep intrinsic principle in tax law, it is the natural law of the parasite: do the least damage to the host in extracting sustenance from it. True, some parts of tax law can be said to be governed by fairly strong principles. Gunn observes correctly that there is a strong principle of taxing wages to the earner that is sufficient to justify the results in the assignment of income cases.⁴⁹ But such principles are local in operation. In much of tax law, the quest for principle is Quixotic. There is no principled answer to the question I posed earlier: May a limited liability company be converted into a corporation to qualify for a tax free merger with a corporation? The law of tax-free reorganizations is not entirely unprincipled—a tax-free reorganization requires some continuity of ownership and assets⁵⁰—but the example does not violate this principle. Once we get past this principle, whether a reorganization is tax-free is a matter of form. A merger of corporations is tax-free (if done in an approved form)⁵¹ and so is a merger of partnerships,⁵² but there is no provision in the law making the merger of a partnership and a corporation tax-free. This is true despite the fact that today there is no relevant distinction between a partnership and a corporation.

The last example does not establish that in a case of an abusive transaction no principled basis for the decision will be available. Perhaps no principle can be identified in the example because there is no abuse. In most cases of abuse, a principle can be identified, at least after the fact. This is Gunn’s point. Later experience supports Gunn’s thesis for there is no shortage of principled explanations for recent decisions relying on the

49. Gunn, *supra* note 4, at 760-65.

50. This principle is instantiated in the common law requirements of continuity of interest, which traces back to *Pinellas Ice & Cold Storage Co. v. Commissioner*, 287 U.S. 462 (1933), and the regulatory requirement of continuity of business enterprise found in Treas. Reg. § 1.368-1(d).

51. See I.R.C. § 368 (1989).

52. The developing body of rules on partnership mergers are mostly in the regulations governing the recognition of pre-contribution built-in gain or loss. See Treas. Regs. §§ 1.704-4(c)(4), 1.737-2(b).

standards of tax motive and economic substance.⁵³ To rebut Gunn's argument that we can always formulate a principled basis for deciding that a transaction is abusive, which can be applied without regard to tax motive or economic substance, I need to come at it from the other direction. Only by going from principle to case can I show that sometimes principles must be qualified by the elements of tax motive and economic substance.

I use an example from the partnership area. As a general matter, shifts of interests in a partnership, either by transfer of an interest or by contribution or distribution of assets, ought not shift or duplicate income or loss among partners, or alter the character of a partner's income or loss.⁵⁴ One could say that this is a principle of subchapter K in the sense that this principle best explains the rules and their evolution. Violations of the principle have narrowed over time. But violations remain, the most prominent resulting from the elective nature of basis adjustments on partnership distributions.⁵⁵ The transaction in the *ACM* case exploited precisely this "loophole" in tax law along with an elective rule in the old installment sale regulations that artificially accelerated income. If I had to state a principled basis for the decision in *ACM*, it would be the principle against shifting or duplicating losses. But the taxpayer could respond that they were within an established exception to the principle. The partnership anti-abuse regulations solve this conundrum by taking the position that partners can choose not to make a section 754 election, though they know this will duplicate losses, so long as they reached the position where this choice was presented in the ordinary course of business.⁵⁶ What is abusive is to do what was done in *ACM*—to enter a partnership that has little or no economic substance with the goal from the start of creating an artificial loss.⁵⁷ The message is that you can pick up tax gold if you find it in the street while going about your business, but you cannot go hunting for it.

The anti-stripping ruling and regulations⁵⁸ lead to a similar problem that can be resolved in the same way. The ruling and regulations target "obligation-shifting transactions" in which one person assumes an obligation to provide property or services in the future for which another person has already been paid (and taxed on the payment). The ultimate principle violated is the same principle against shifting or duplicating losses, now operating outside of subchapter K. Richard Lipton has ar-

53. I trace the history of recent anti-abuse decisions in subchapter K and explain how Treasury gradually developed middle range principles to justify the rulings in Mark P. Gergen, *Subchapter K and Passive Financial Intermediation*, 51 SMU L. REV. 37, 68-73 (1997). For alternative principled accounts of *Saba* and *ACM*, which involved the same shelter, and *Compaq*, see Trier, *supra* note 5, at 72-80.

54. For statements of this principle, see William D. Andrews, *Inside Basis Adjustments and Hot Asset Exchanges in Partnership Distributions*, 47 TAX L. REV. 3 (1991); Karen C. Burke, *Partnership Distributions: Options for Reform*, 3 FLA. TAX REV. 677, 704 (1998).

55. I.R.C. §§ 734(b), 754 (2000).

56. Treas. Reg. § 1.701-2(d) (ex. 9).

57. Treas. Reg. § 1.701-2(d) (ex. 8).

58. See Treas. Reg. § 1.7701(l)-2; I.R.S. Notice 95-53, 1995-2 C.B. 334.

gued that the principle stated in the regulations is overbroad because it might apply to “[a]ny sale of property that occurs after rent prepayments.”⁵⁹ We can answer that the principle does not apply if the rent prepayments and sale were not part of a plan to create an artificial loss to benefit the buyer of the property. This would be found tax gold, not made tax gold.

These examples show that sometimes principles must be qualified by the elements of tax motive and economic substance because the principles are not absolute, which brings us to the nub of the matter. One consequence of pursuing the course advocated by Gunn—which is to eschew the standards of tax motive and economic substance to decide abuse cases entirely on grounds of principle—is to give the judicial and executive branches greater power to eliminate deviations from principle in tax law on a case-by-case basis. The standards of tax motive and economic substance implicitly limit this power to cases where the taxpayer is consciously trying to exploit a flaw in tax law through actions that have no substance. To make this abstract point more concrete, consider the consequences of untethering the principle against allowing shifts in partnership interest to yield artificial losses from the standards of tax motive and economic substance. This would change the result in example 9 of the section 701 regulations, which states that partners may elect not to make basis adjustments upon a distribution even though they know at the time of distribution that this will create an artificial loss by duplicating a loss.⁶⁰ The standards of tax motive and economic substance are a product of our commitment to rules in the sense that they follow from a judgment that principle should not always trump over rule.

This only addresses Gunn’s argument that the elements of tax motive and economic substance should play no role in the law. There remains a great deal of force in his arguments even after this hard edge is taken off. It should be a truism that the more guidance or authority an official can take from tax law (however broadly defined), the less weight she need place on the elements of tax motive or economic substance. For example, if an official concludes that a rule-maker would not have intended for a rule to apply in a situation, though the rule’s text is to the contrary, then she could decide on interpretive grounds without concerning herself with tax motive or economic substance.⁶¹ And I expect that no one would

59. Richard M. Lipton, ‘*Obligation-Shifting*’ Prop. Regs.—*Is Deemed Loan Treatment the Right Approach?*, 86 J. TAX’N 209, 211 (1997).

60. See Treas. Reg. § 1.701-2(d) (ex. 9).

61. The FASIT rules offer an arcane example. It is essential that a residual interest in a FASIT be held by a tax-paying entity so the statute prohibits most tax-indifferent entities from owning a residual interest, but omits Indian tribes. The industry took advantage of this omission by placing residual interests with Indian tribes. One need not decry the tax motive behind this act to hold that Indian tribes are not qualified to be owners of residual interests. It is plain that Indian tribes would have been included in the statutory prohibition had the possibility crossed anyone’s mind. For more on this tawdry story, see Calvin H. Johnson, *Law Professor Mocks Corporate Tax Shelter Legislation*, 84 TAX NOTES 443 (1999).

take issue with the proposition that reasoned decisions are better than unreasoned decisions. My point is a fairly modest one. Logic will take us only so far. Some decisions are not reducible to principles that can be stated authoritatively or that can be applied axiomatically. Anti-abuse law in this respect is like the common law: "it lacks an authoritative authentic text; . . . it ' . . . professes. . . to develop and apply principles that have never been committed to any authentic form of words.'"⁶²

This explanation of the function played by the standards of tax motive and economic substance is conducive to David Weisbach's economic argument for anti-abuse standards.⁶³ Weisbach argues that the combination of simple rules and anti-abuse standards may best balance the interests in accurately measuring income, minimizing compliance and administrative costs, and minimizing distortionary effects of tax on behavior.⁶⁴ The rules governing basis adjustments upon shifts in partnership interests provide a concrete illustration. Adjustments are made elective for administrative reasons. Adjustments require valuation of partnership assets, which can be costly, and accounting for adjustments can be quite cumbersome. In making adjustments elective, the interest in accurately measuring income gives way to the interest in minimizing compliance and administrative costs.⁶⁵ This may be well and good as long as the resulting errors in the measurement of income are inadvertent. But the temptation is created for actors to alter their conduct, sometimes incurring real non-tax costs, to reap a tax benefit by exploiting the rule not requiring adjustments. Such behavior exacerbates the mismeasurement of income and to the extent transaction or other costs are incurred in the effort, the behavior also compromises the rule's administrative benefits. Two possible responses are to change the general rule to require basis adjustments upon all shifts in interests, or to add a rule to require adjustments in a defined subset of cases where measurement errors are likely to be most favorable to tax-

62. A.W.B. SIMPSON, *The Common Law and Legal Theory*, in LEGAL THEORY AND LEGAL HISTORY 359, 370 (1987) (quoting F. POLLOCK, A FIRST BOOK OF JURISPRUDENCE 249 (3d ed. 1911)).

63. Weisbach, *supra* note 10.

64. David Weisbach and Daniel Shaviro show that a more complete economic analysis is quite complex. One complicating factor is that an anti-abuse standard or rule may worsen the distortionary effect of the rule mismeasuring income by inducing actors to alter their behavior in costly ways to cloak their actions with substance. Further, a rule may distort behavior in ways that offset other tax distortions of behavior and so the net effect is to enhance welfare. For an integrated analysis taking account of both phenomena, see Shaviro, *supra* note 10, at 237-38. I discuss the latter phenomenon in exploring the question of whether the creation of equity-hybrids that provide the issuer an interest deduction on equity-like instruments might reduce the harmful distortionary effects of the corporate income tax in Mark P. Gergen & Paula Schmitz, *The Influence of Tax Law on Securities Innovation in the United States: 1981-1997*, 52 TAX L. REV. 119, 184-92 (1997). We conclude that on balance the effect of hybrids probably is harmful but note that it is an empirical question upon which there is insufficient data.

65. For an argument that these tradeoffs are susceptible to utilitarian calculus by examining the social welfare functions of individuals who benefit by the mismeasurement of income and those who are hurt by it (primarily those who bear the additional tax burden), see Louis Kaplow, *How Tax Complexity and Enforcement Affect the Equity and Efficiency of the Income Tax*, 49 NAT'L TAX J. 135 (1996).

payers. But these responses increase compliance costs, in the first instance, across the board and in the second, in all transactions within the penumbra of the exception to the general rule. Conditioning application of the general rule on the absence of tax motive and the presence of economic substance may restore something approximating the original balance by suppressing efforts to exploit the general rule. A virtue of the standards of tax motive and economic substance is that they ought to impinge little on non-tax driven business decisions. Of course, there is a corresponding vice—the standards poorly suppress the behavior they aim at because of their generosity and because they are not self-executing. But it is at least conceivable that the simple rule and anti-abuse standards strike the best balance. This is a rough sketch of Weisbach's argument.

One point Weisbach might take from Gunn is that the debate regarding anti-abuse law raises an important question that goes beyond the "rules/standards problem" and economic analysis.⁶⁶ The key difference between rules and standards is when the law's command is given content. Under a rule it is done *ex ante*. Under a standard it is done *ex post* or retroactively. Gunn endorses retroactive law making in response to tax abuse but rejects the standards of tax motive and economic substance.⁶⁷ There is no contradiction here. The common law methods of reasoning by analogy and reasoning from principle can be "flexible [and] context-sensitive" and not "formal and mechanical," much like standards.⁶⁸ The method of reasoning from statutory purpose can have the same qualities. Ideally, a standard states the normative criteria that officials will apply case-by-case to determine the law's command. The risk-utility standard for design defects in the law of products liability is a good example.⁶⁹ The stated elements of the standards of tax motive and economic substance are purely factual. The normative element is implicit. One way to express Gunn's challenge to the standards is he thinks that the normative element of the analysis ought to be made explicit; that reasoning from analogy, from principle, or from purpose are the proper techniques, and that skillful employment of these techniques can obviate the need to advert to tax motive or economic substance. This challenge can be answered only from an internal-to-law perspective. My answer is that these methods run afoul of our commitment to rules.

Putting Weisbach's work along side the work of an earlier time shows the sea change that has occurred in tax scholarship. Gunn and Isenbergh's arguments are first and foremost arguments of tax law, and their normative criteria—the criteria of coherency, consistency, and clarity—

66. Weisbach, *supra* note 10, at 864.

67. See Gunn, *supra* note 4, at 767.

68. Standards usually are defined in contraposition to rules in the following way: "Rules are legal norms that are formal and mechanical. They are triggered by a few easily identified factual matters and are opaque in application to the values that they are designed to serve. Standards, on the other hand, are flexible, context-sensitive legal norms that require evaluative judgments in their application." Larry Alexander & Ken Kress, *Against Legal Principles*, 82 IOWA L. REV. 739, 740 (1997).

69. See RESTATEMENT (THIRD) OF TORTS: PRODUCTS LIABILITY § 2(b) (1997).

are, in a sense, intrinsic to the law. Weisbach's argument is *about* tax law—it is about what form of tax law is most efficient—it is not an argument *of* tax law. In Weisbach's analysis, the value of coherency, consistency, and clarity is entirely instrumental.

A strength of the economic perspective is that by taking us outside the law it helps untangle some knotty doctrinal problems. It puts in perspective the elusive concepts of form and substance. Joseph Isenbergh has said: "When we are dealing with statutory terms of art, the form-substance dichotomy is a false one. 'Substance' can only be derived from forms created by the statute itself. Here substance *is* form and little else; there is no natural law of reverse triangular mergers."⁷⁰ The implication is that some things do exist outside the law and that for these "real" things the form-substance dichotomy is meaningful. But tax law is artificial through and through. Tax law rules largely refer to phenomena—corporation, debt, equity, ownership, sale—that, while they may exist outside tax law, still are matters of human artifice. Further, these phenomena poorly correspond with what we are trying to measure with the rules of tax law (typically income) or what we are trying to do with the law (ultimately raise revenue at the least cost). The artificiality of tax law is especially apparent in the area of corporate finance today because tax law employs business and accounting concepts that modern finance has deconstructed.⁷¹ The problem is not unique to the financial arena. Sham divorces are possible only in a world where the acts of marriage and divorce can be understood as devoid of real significance or meaning.

Artificial concepts are a poor tool for regulating opportunistic tax planning. Dana Trier has argued that *Esmark, Inc. v. Commissioner*⁷² was an easy case because it "came down to whether Mobil was ever the owner of stock for tax purposes . . . [and] there was no other better candidate for ownership of the stock [in question] than Mobil."⁷³ This argument is difficult to accept on its face. Trier concedes the plasticity of the concept of ownership—property is, tritely, a bundle of sticks—while insisting on a highly formal definition—in Trier's view, there is always an owner, and it is whoever has the most sticks in the bundle no matter how small his handful.

Two general propositions tend to press on the minds of people who try to solve the puzzle of anti-abuse law. One is that "a more complex, tax advantaged way of executing a transaction should not lack economic substance if the transaction itself has economic substance."⁷⁴ The other proposition is that anti-abuse law is peculiarly concerned with transactions

70. Isenbergh, *supra* note 1, at 879.

71. See Jeff Strnad, *Taxing New Financial Products: A Conceptual Framework*, 46 *STAN. L. REV.* 569 (1994).

72. 90 T.C. 171 (1988), *aff'd*, 886 F.2d 1318 (7th Cir. 1989).

73. Trier, *supra* note 5, at 69-70. Mobil acquired the Esmark stock for cash in a pre-arranged deal designed to acquire an Esmark subsidiary without Esmark recognizing gain on the sale of the subsidiary.

74. Hariton, *supra* note 5, at 236.

designed to create artificial losses, what Trier calls "loss generators."⁷⁵ Both propositions echo in Judge Cohen's distinction of *Compaq* and *Es-mark*. There is a difference, he said, "between (1) closing out a real economic loss in order to minimize taxes or arranging a contemplated . . . transaction in a tax-advantaged manner and (2) entering into a prearranged loss transaction designed solely for the reduction of taxes on unrelated income."⁷⁶ In other words, while actors may be free to time the realization of gains and losses to their advantage, they are not free to enter into transactions solely to create artificial losses to shelter income. As a descriptive matter, these observations are accurate only as expression of tendencies in the law; they do not pass as categorical rules or principles. There was a real transaction at the heart of the transaction in the *ACM* case, a debt repurchase by Colgate.⁷⁷ And many anti-abuse cases involve issues of timing. Still these propositions press on the mind because they are consistent with the day-to-day experience of tax lawyers. Often transactions may be structured in multiple ways with different tax consequences. There is a great deal of control over the timing of gain and loss. And it is very difficult to shelter income.

An advocate for weaving these or other precepts into anti-abuse law might concede their descriptive weakness but argue that there is no better alternative. As we have seen, the standards of tax motive and economic substance are overbroad. The substantive principles we can discern in tax law are not absolute. The phenomena referred to in tax law are artificial. An economic perspective may help us understand the value of the standards of tax motive and economic substance, but for many reasons, we do not want officials to pass on the merits of specific transactions by asking what rule is efficient for that transaction.

But economic analysis points to another possible solving criteria to supplement the standards of tax motive and economic substance. It is the same criteria to which legal analysis points. From an allocative perspective, the evil in exploitative tax planning lies more in the effort spent in playing the game than in the outcome. The outcome is mostly of distributive significance.⁷⁸ Logically, the game is most costly to play when it is

75. Trier, *supra* note 5, at 66.

76. *Compaq Computer Corp. v. Comm'r*, 113 T.C. 214, 220 (1999).

77. Hariton tries to explain this away. "If one eliminated the CINS transaction, however, the subsequent repurchase of Colgate debt would not have been affected Moreover, the relevant tax benefit (a large capital loss) bore no relation to the repurchase of outstanding debt." Hariton, *supra* note 5, at 236. This leaves little substance to the initial proposition. With this modification, "a more complex, tax-advantaged way of executing a transaction" of substance will lack economic substance if the tax-advantaged feature or step was not essential to completion of the transaction or if the tax benefit did not bear the proper relationship to the transaction. *Id.*

78. I expect that individual tax avoidance redounds largely to the benefit of the well-to-do. If we assume that the burden of the revenue loss is borne generally, then there will be some welfare loss in the distributive effects. To determine the welfare effects of the distributive consequences of corporate tax avoidance, we would need to know who bears the burden of the corporate income tax. A complication is that it is not necessarily the case that there is no social value in resources spent playing the tax game. Contracts or arrangements that are devised for their tax benefits may have social value. The concept of the

played in novel ways, and the incentive to play in novel ways is greatest when novel ends are sought. Novelty, then, is the solving criteria. The standards of tax motive and economic substance ought to target novel plans to achieve novel tax ends. What is novel depends on what tax lawyers commonly do and have done, as well as visible positive tax law and the principles that might be said to be immanent in the law.

No doubt lawyers and law-minded scholars will continue to try to rationalize anti-abuse law around a verbal formula that does not leave the issue so up in the air. Learned Hand's career-long struggle with the issue of form and substance in tax law is a cautionary tale for those who pursue this grail.⁷⁹ Hand saw that a policy of literalism sometimes was untenable in tax law,⁸⁰ that an inquiry into legislative purpose often was an unsatisfactory alternative,⁸¹ and that solving concepts could not always be found outside tax law.⁸² But neither would he condemn tax saving actions tout court.⁸³ Given his "penchant for logical statement,"⁸⁴ nor could Hand could be satisfied with leaving the distinction between abusive and non-abusive tax planning a matter of common understanding or intuition. In his "last major encounter with the subject of tax avoidance,"⁸⁵ Hand tried to define abuse in terms of economic substance. The form of an act would be respected for tax purposes, Hand wrote, only if the actors did "suppose that the difference[s] would appreciably affect their beneficial interests . . . other than taxwise."⁸⁶ Marvin Chirelstein has translated this as a rule that "ambiguous transactions were to be characterized in the Commissioner's favor, unless the taxpayer could dispel the ambiguity by showing that the form which he had chosen carried with it, or was expected to carry with it, some appreciable economic effect beyond tax savings."⁸⁷ Neither will do. This "rule" is terribly overbroad. It becomes

trust originates in tax avoidance. Some valuable financial innovations in recent years may have been partly stimulated by tax benefits. See Gergen & Schmitz, *supra* note 64, at 150, 170-74 (giving as examples zero coupon bonds, the Eurobond market, and LYONS).

79. This history is engagingly told in Chirelstein, *supra* note 44.

80. The classic statement of this is set forth in *Helvering v. Gregory*, 69 F.2d 809, 810-11 (2d Cir. 1934).

81. See Chirelstein, *supra* note 44, at 473.

82. As Chirelstein tells the story, Hand was not entirely consistent on this. He initially took the position "that the separate status of corporation and shareholder could not thus be disregarded," which case was subsequently reversed by the Supreme Court in *Higgins v. Smith*, 308 U.S. 473 (1940). Chirelstein, *supra* note 44, at 448. Hand solved this particular puzzle by reasoning that the separate status of corporation and shareholder could not be disregarded if the corporation "does some 'business' in the ordinary meaning." *Id.* at 450-51 (quoting *Nat'l Investors Corp. v. Hoey*, 144 F.2d 446, 468 (2d Cir. 1944)). In *Gilbert v. Commissioner*, 248 F.2d 399, 412 (2d Cir. 1957), Hand rejected the position that whether a shareholder could take a bad debt deduction on money advanced to the corporation could be resolved by asking whether the advance would be treated as a debt for non tax purposes.

83. For a famous statement of this position, see *Commissioner v. Newman*, 159 F.2d 848, 850-51 (2d Cir. 1947) (Hand, J., dissenting).

84. Chirelstein, *supra* note 44, at 473 (quoting Maurice Finkelstein, *The Corporate Entity and the Income Tax*, 44 *YALE L.J.* 436, 449 (1935)).

85. *Id.* at 459. Hand was writing in dissent in *Gilbert*.

86. *Gilbert*, 248 F.2d at 412.

87. Chirelstein, *supra* note 44, at 464.

terribly underbroad if one adds to the rule, as Chirelstein suggests, that Hand may have implied, a limitation of the rule to transactions not between unrelated parties.⁸⁸ If Learned Hand could not rationalize anti-abuse law, we are unlikely to do better. Still those who pursue the grail should be applauded for their pursuit bespeaks a belief in the integrity of tax law. The health of tax law depends upon practitioners believing that it is principled.

88. *See id.* at 469-70.

