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Lost on a One-Way Street: The Taxpayer's Ability to Disavow Form

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INTRODUCTION

"Just as the Commissioner in determining income tax liabilities may look through the form of a transaction to its substance, so, as a general rule, may he bind a taxpayer to the form in which the taxpayer has cast a transaction."[1]

"The taxpayer as well as the Government is entitled to the benefit of the rule that the substance rather than the form of a transaction controls."[2]

The principle that the government alone may appeal to the substance of a transaction pervades federal tax law.[3] Every taxpayer seeking to disavow the form of a transaction must consider the possibility that substance arguments create a one-way street in favor of the government. This "one-way rule" emerges in transactions as diverse as intercompany transfers, corporate mergers, sale-leasebacks, and divorce settlements.

Despite its pervasiveness, the one-way rule[4] is in apparent disarray.[5] Courts are deeply divided over whether an appeal to substance should receive a different reception depending on whether the taxpayer or the government makes it.[6] In one sense, making the

[1] Spector v. Commissioner, 641 F.2d 376, 381 (5th Cir.) (citations omitted), *cert. denied*, 454 U.S. 868 (1981).

[2] Ciaio v. Commissioner, 47 T.C. 447, 457 (1967).

[3] For general surveys of this principle, see 1 B. BITTKER & L. LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS 3.6, 4.4.6 (2d ed. 1989) (discussion of disavowal of form by taxpayers and attempts by taxpayers to restructure transactions); Burstein, *The Impact of Form, and Disavowing Form, on the Characterization of Sales Transactions*, 66 TAXES 220 (1988). For articles describing situations in which the principle did not apply, see Donaldson, *When Substance-Over-Form Argument is Available to the Taxpayer*, 48 MARQ. L. REV. 41 (1964); Rosen, *Substance Over Form — A Taxpayer's Weapon*, 22 MAJOR TAX PLAN. 689 (1970); Smith, *Substance and Form: A Taxpayer's Right to Assert the Priority of Substance*, 44 TAX LAW. 137 (1990).

[4] In this Article the "one-way rule" refers loosely to the rule binding the taxpayer to the form of the transaction for tax purposes. More precisely, the rule grants less weight to taxpayer appeals to substance than to those made by the government. On occasion, the term refers to assymetrical rules that tend to disadvantage the taxpayer. *See* I.R.C. §§ 267, 1091, 1251 (1991).

[5] *See* Rosen, *supra* note 3, at 742-43 ("[I]t is impossible to deduce specific universally applicable legal principles which will provide a relatively automatic answer in situations where the taxpayer desires to invoke substance as a defense against imposition of a tax liability based on the form of his own transaction."); Donaldson, *supra* note 3, at 45 (describing taxpayer's right to argue against form as "a rough and unmarked road").

[6] For cases adopting the one-way rule, see Commissioner v. National Alfalfa Dehydrating & Milling Co., 417 U.S. 134 (1974); Higgins v. Smith, 308 U.S. 473 (1940); Schatten v. United States, 746 F.2d 319 (6th Cir. 1984); Commissioner v. Danielson, 378 F.2d 771 (3d Cir.), *cert. denied*, 389 U.S. 858 (1967); Television Indus., Inc. v. Commissioner, 284 F.2d 322 (2d Cir. 1960); Ullman v. Commissioner, 264 F.2d 305 (2d Cir. 1959); United States v. Morris & Essex R.R., 135 F.2d 711 (2d Cir.), *cert. denied*,

weight given an argument dependent on its source, or pedigree, denies even-handed application of the law.[7] In another sense, an asymmetrical approach balances the advantage adhering in the taxpayer's control of form.

Confusion over the rule does not stop there. Even courts adopting a one-way rule differ over its meaning. Some courts forbid the taxpayer from appealing to substance;[8] others allow the taxpayer to appeal to substance but raise his burden of proof;[9] and still others mention his status as a taxpayer as merely a factor in their decisions.[10] Indeed, the rule seems to be a common banner hung over several very different doctrines.[11]

This Article endeavors to bring method to this madness by placing the rule in its broader context and analyzing it historically. This methodology explains the present status of the rule and suggests normative considerations for its future application.

Along the way, the Article yields insights that extend into tax law, administrative law, and statutory interpretation. The one-way rule is but a thread in a larger legal tapestry. In analyzing the rule, the Article traces far-reaching historical trends of the last fifty

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320 U.S. 754 (1943); Coleman v. Commissioner, 87 T.C. 178 (1986), *aff'd*, 833 F.2d 303 (3d Cir. 1987); Bolger v. Commissioner, 59 T.C. 760 (1973).

For cases rejecting the one-way rule, see Bartels v. Birmingham, 332 U.S. 126 (1947); Moline Properties, Inc. v. Commissioner, 319 U.S. 436 (1943); Strick Corp. v. United States, 714 F.2d 1194 (3d Cir. 1983), *cert. denied*, 466 U.S. 971 (1984); Estate of Weinert v. Commissioner, 294 F.2d 750 (5th Cir. 1961); Landa v. Commissioner, 206 F.2d 431 (D.C. Cir. 1953); Freeport Transp., Inc. v. Commissioner, 63 T.C. 107 (1974); Shaw v. Commissioner, 59 T.C. 375 (1972).

[7] *See, e.g.*, Peerless Steel Equip. Co. v. Commissioner, 26 T.C.M. (CCH) 880, 883 (1967) ("Though there may be some attractive reasons for requiring a taxpayer to adhere to the form that he has created, the even-handed application of the law requires us to allow taxpayers the opportunity to show that their true intent was different from what was said . . . ."); Rosen, *supra* note 3, at 731 ("fairness dictates an even-handed application of the rule that substance should govern in the field of taxation"); Smith, *supra* note 3, at 178-79 (because of its affront to evenhandedness, courts should apply the one-way rule only in compelling circumstances); Special Committee on Whipsaw, *Final Report*, 30 TAX LAW. 127, 133 (1976) (expressing concern for possibility that government may whipsaw taxpayers).

[8] *See, e.g.*, *Higgins*, 308 U.S. 473.

[9] *See, e.g.*, *Danielson*, 378 F.2d 771; *Ullman*, 264 F.2d 305.

[10] *See, e.g.*, *National Alfalfa*, 417 U.S. 134; *Television Indus., Inc.*, 284 F.2d 322.

[11] Thus, several courts have rejected one form of the rule while adopting another. *See, e.g.*, Strick Corp. v. United States, 714 F.2d 1194, 1206 (3d Cir. 1983) (rejecting a rule that would escalate the taxpayer's burden of proof in challenging form, but nonetheless binding the taxpayer to form), *cert. denied*, 466 U.S. 971 (1984); *Peerless Steel*, 26 T.C.M. (CCH) at 884 (rejecting a rule that would prevent the taxpayer from renouncing the form of its transaction, but nonetheless requiring the production of strong proof in order to make such renunciation).

years: the blurring of sharply drawn boundaries for allocating institutional authority, the decline of mediating constructs such as statutory purpose and economic reality, and the substitution of consistent treatment of the entire transaction for precise taxation of the parties to the transaction in accordance with economic reality.

The Article considers the legal structures underlying in the rule while suspending judgment on the utility of those structures.[12] Its goal is to explain the rule on its own terms. Thus, the Article does not ask whether the distinctions between strict and liberal construction, deference and independent judgment, or formal and substantive interpretation logically collapse. Nor does it consider whether notions such as economic reality have determinant meaning. It asks instead how courts understand such distinctions and notions. By using structuralist techniques to analyze public law rules, the Article complements prior studies, which have usually focused on private law.[13]

The Article consists of four parts. Part One provides a description that has remained relatively constant over the life of the rule. By relating the rule to three broader legal choices, the choices between strict and liberal construction, between independent judgment and agency decisionmaking, and between formal and substantive interpretation, Part One describes in general terms when courts use the rule. Additionally, Part One explains the arguments offered for the one-way rule by relating them to the tension between individualism and communalism.

Part Two places the rule in historical context. It demonstrates how the general relationship described in Part One evolved over time. It shows that the rule moved through three identifiable phases depending on judicial sympathy to tax statutes, how courts defined their relationship to agencies, and the weight they attached to consistent treatment of the parties to the transaction.

Part Three describes the present status of the one-way rule.

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[12] This structuralist approach has roots in anthropology. *See generally* C. LEVI-STRAUSS, STRUCTURAL ANTHROPOLOGY (1963, 1976); Heller, *Structuralism and Critique*, 36 STAN. L. REV. 127 (1984).

[13] *See, e.g.*, Kennedy, *The Structure of Blackstone's Commentaries*, 28 BUFFALO L. REV. 205 (1979); Singer, *The Legal Rights Debate in Analytical Jurisprudence from Bentham to Hohfeld*, 1982 WIS. L. REV. 975.

For one anticipation of structural analysis in tax law, see Balkin, *The Crystalline Structure of Legal Thought*, 39 RUTGERS L. REV. 1, 41 n.68 (1986) (describing arguments in tax cases as "highly complex combinations of structures created by several different axes of opposition").

Viewing the rule as a compromise, it considers the viability of the rule and divisions within it.

Part Four uses the structures described in the first three Parts to develop normative principles for applying the rule. Part Four first develops doctrinal guidelines for adopting the rule and then analyzes more deeply the policy judgments implicit in it. This analysis identifies effects of the rule, generates criteria for its application, and suggests alternatives to it.

PART ONE

A GENERAL EXPLANATION OF THE ONE-WAY RULE

This Part explains the mixed reaction to the one-way rule. By putting the rule in its broader legal context, this Part describes in general terms when courts adopt the one-way rule and how they justify it.

I

THE RELATIONSHIP OF THE ONE-WAY RULE TO BROADER JUDICIAL CHOICES

The adoption of the one-way rule is related to three broader choices in the law. These choices are broader because they arise not only when a taxpayer challenges the form of his own transaction, but also in a wide variety of situations outside tax law.

A. The Choice Between Strict and Liberal Construction

The first choice necessary to understanding the one-way rule is that between two modes of statutory construction. Traditionally, courts placed statutes into two categories, in which some, such as penal statutes, received strict construction, while others, so-called remedial statutes, received liberal reading to achieve their intended purposes.[14]

Each mode has its claim to justice. Strict construction protects the individual taxpayer from state action. Liberal construction implements the public purpose underlying the statute.

It is difficult to fit tax statutes into this scheme. Specifically, in doubtful cases, should the Internal Revenue Code (Code) be read strictly against the Commissioner or liberally in favor of the fisc? In the early twentieth century, the majority rule was strict construc-

[14] *See* J. SUTHERLAND, STATUTES AND STATUTORY CONSTRUCTION 435-520 (1891) (chapter on strict construction); *id.* at 521-72 (chapter on liberal construction).

tion, with a minority of courts favoring liberal construction.[15] Later in the century, courts refrained from applying either strict or liberal construction in favor of "reasonable"[16] or neutral construction.[17] Neither environment is hospitable to the one-way rule, which serves only to broaden the scope of tax statutes.

B. *The Choice Between Deferring to Agency Interpretation of Law and Exercising Independent Judgment*

The second judicial choice critical to understanding the one-way rule involves the scope of review given to interpretations of law made in administrative adjudication. In reviewing the application of law to facts made in such an adjudication, courts select one of two alternative modes.[18]

Under the mode of independent review, taxpayer and government arguments receive the same weight.[19] Viewing the action like a private lawsuit, the court treats the agency determination no differently from the position of a private party. Fairness under this mode dictates that a court consider an argument without respect to its "pedigree," or source, unless the other party reasonably but detrimentally relied on the argument.

The alternate mode, deference to agency position, affords preferential treatment to the government. Recognizing the public function served by the agency, the court reviews the agency's disposition of the case. Fairness under this mode permits consideration of the argument's pedigree.[20]

Each mode has appeal. Independence makes judicial review meaningful. Deference recognizes the lawmaking function of agencies.

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[15] *See* 2 J. SUTHERLAND, STATUTES AND STATUTORY CONSTRUCTION 999 (J. Lewis 2d ed. 1904).

[16] *See* 3A J. SUTHERLAND, STATUTES AND STATUTORY CONSTRUCTION § 66.02 (N. Singer 4th ed. 1986).

[17] *See* Griswold, *An Argument Against the Doctrine that Deductions Should be Narrowly Construed as a Matter of Legislative Grace*, 56 HARV. L. REV. 1142, 1146 (1943). An exception has been the maxim favoring strict construction of exceptions to tax statutes. *See id.* at 1146-47.

[18] *See, e.g.*, Farina, *Statutory Interpretation and the Balance of Power in the Administrative State*, 89 COLUM. L. REV. 452, 453-54 (1989) (describing "independent judgment" and "deferential" models of the relationship of court and agency); Breyer, *Judicial Review of Questions of Law and Policy*, 38 ADMIN. L. REV. 363, 365-67 (1986) (describing opposing judicial attitudes of deference and independence).

[19] *See* Diver, *Statutory Interpretation in the Administrative State*, 133 U. PA. L. REV. 549, 559 (1985).

[20] *See id.*

In administrative law generally, courts divide between these two modes, although deference is the general rule.[21] In tax law, deference to Internal Revenue Service (IRS) legal positions, if any, is reserved for interpretations made in regulations and rulings.[22] Courts exercise independent judgment on legal and factual issues in refund suits[23] and deficiency actions.[24] Thus, the IRS's prior disposition of the case receives no additional weight in court.[25]

This climate generates judicial resistance to the one-way rule. By leaving the door open to IRS challenges to form on like facts, the one-way rule shifts decisionmaking from the courts to the IRS. Although not so formulated, the rule operates as a rule of deference because it reduces, often to zero, the weight given the taxpayer's position in a broad array of cases. By escalating the burden of proof borne by the taxpayer, the one-way rule effectively defers to the Commissioner's litigating position. Such deference is difficult to square with settled principles denying special weight to prior IRS determinations.

C. *The Choice Between Formal and Substantive Interpretation*

The third judicial choice important to understanding the one-way rule is that between formal and substantive interpretation. This choice is implicit whenever a court interprets a contract, statute, or constitution. It applies to determinations of law and of fact alike.

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21 *See id.* at 598.

22 *See* I.R.C. § 7805 (1991). For this purpose, "rulings" include only rulings published in the *Internal Revenue Bulletin*. *See* Mim. 3290, IV-1 C.B. 321 (1925).

23 *See* National Right to Work Legal Defense and Educ. Found., Inc. v. United States, 487 F. Supp. 801, 805 (E.D.N.C. 1979) ("[T]he factual and legal analysis of the Commissioner is of no concern to the district court. The court's determination is *de novo*.") (citation omitted); Pierson v. United States, 428 F. Supp. 384, 388 (D. Del. 1977) (In an ordinary refund action, "the Court must place itself in the shoes of the Commissioner.").

24 *See* B. B. Todd, Inc., 1 B.T.A. 762, 764 (1925) (The Board of Tax Appeals' "duty [is] to determine from the statute whether the tax asserted by the Commissioner is properly due."). In another case, the Board of Tax Appeals stated:

> It is no part of the duty of this Board, nor has it the right, to decide in any manner questions of policy in the administration of the office of the Commissioner. It is the duty of this Board to decide appeals filed by taxpayers upon the facts and the law as applied to their cases.

Cleveland Home Brewing Co., 1 B.T.A. 87, 91 (1924).

25 The taxpayer, however, bears the burden of proof. T.C.R. 142(a). *See* United States v. Janis, 428 U.S. 433, 440 (1976) ("In a refund suit the taxpayer bears the burden of proving the amount he is entitled to recover."). Martinez lists many justifications for the rule. *See generally* Martinez, *Tax Collection and Populist Rhetoric: Shifting the Burden of Proof in Tax Cases*, 39 HASTINGS L.J. 239 (1988).

Like the other broader choices, the choice between formal and substantive interpretation is between competing modes. Formal interpretation looks to the literal language of the text. It conserves judicial resources, curbs official arbitrariness, and permits private actors to structure their affairs. A court that is indifferent to the ultimate result would find formal decisionmaking to be a useful means of affording private actors certainty in structuring their affairs.[26]

In contrast, substantive interpretation departs from the literal meaning of the text in order to achieve a just outcome. Substantive decisionmaking avoids the inevitable under- and over-inclusion of formal rules and permits fine tuning to achieve the correct result on particular facts. A court concerned about the ultimate result would choose a substantive approach in order to prevent manipulation of the rules through the use of form.[27]

Over the long run, courts are unlikely to limit themselves to either formal or substantive interpretation. Formal decisionmaking condones injustice in under- or over-inclusive cases and permits manipulation of the rules. Substantive decisionmaking consumes judicial resources, permits official arbitrariness through unprincipled recharacterization of transactions, and creates uncertainty for private actors.[28]

The choice between formal and substantive interpretation differs from that between strict and liberal construction. Admittedly, formal interpretation frequently narrows a statute while substantive interpretation often broadens it. But this effect is not logically mandated. Depending on the context, formal interpretation can expand the scope of a statute, and substantive interpretation can narrow it. For example, to read an exception for surgery into a statute prohibiting the "shedding of blood" is to engage in a substantive interpretation that narrows the statute.

On occasion, courts resolve the difficult choice between formal and substantive interpretation by resorting to mediating terms that appear to embody the virtues and exclude the vices of both modes. In interpreting statutes, courts look for "legislative intent" or "statutory purpose," terms that avoid rigidity while circumscribing judi-

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[26] *See* Kennedy, *Form and Substance in Private Law Adjudication*, 89 HARV. L. REV. 1685, 1688 (1976).

[27] *See id.* at 1689.

[28] For further discussion of formal and substantive decisionmaking, see Balkin, *supra* note 13, at 43-45; Kennedy, *supra* note 26, at 1687-1701.

cial discretion.[29] Likewise, in interpreting contracts, focus on the parties' intent permits courts to avoid woodenness while limiting their leeway.

In tax law, "economic reality" serves the same mediating function as "intent" or "statutory purpose." Indeed, in a general sense, the "purpose" of the Code may be to tax economic reality. By "economic reality," I mean an objective characterization of a transaction that stands independent of its tax consequences. Courts describe such characterization as "reality"[30] or "substance."[31] Although ostensibly a characterization of fact, economic reality also serves as a basis for determining how the statute will apply.

Reliance on economic reality allows a court to avoid wooden application of a statute and rigid adherence to form while restricting judicial departure from the statute and recharacterization of transactions. Such reliance circumscribes judicial recharacterization and avoids the under- and over-inclusiveness of formal rules. It provides a measure of certainty to taxpayers when form is meaningful and prevents manipulation when form is not.

Economic reality has been the guiding principle in federal taxation since at least 1921[32] and has been described as "the cornerstone of sound taxation."[33] Despite this consensus, or perhaps because of it, there is no single generally accepted definition of economic reality. One possible touchstone is the Haig-Simons definition of personal income: (1) market rights exercised in consumption plus (2) the change in the value of property rights.[34]

Another definition of economic reality looks to the commercial "norm" for the transaction. This norm may be borrowed from other bodies of law,[35] such as corporate or property law. Alternatively, it can be based on the commercial practice of unrelated persons acting at arm's length, or be derived from assumptions implicit in the statutory scheme, as when courts add the requirements of business purpose and continuity of interest to the literal definition of

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29 *See* Blatt, *The History of Statutory Interpretation: A Study in Form and Substance*, 6 CARDOZO L. REV. 799, 828-34 (1985).

30 *See* Commissioner v. Southwest Exploration Co., 350 U.S. 308, 315 (1956).

31 *See* Campbell v. Fasken, 267 F.2d 792, 796 (5th Cir. 1959).

32 *See* United States v. Phellis, 257 U.S. 156, 168 (1921).

33 Estate of Weinert v. Commissioner, 294 F.2d 750, 755 (5th Cir. 1961).

34 H. SIMONS, PERSONAL INCOME TAXATION 50, 61-62, 206 (1938).

35 For a striking example of a case deriving economic reality from federal banking law, see Commissioner v. First Sec. Bank of Utah, 405 U.S. 394 (1972) (Commissioner's authority to allocate income among related corporations does not permit allocation of income that could not have been lawfully received under banking law).

reorganization.[36]

Mediating terms sometimes break down. Intent and statutory purpose become empty concepts. Likewise, economic reality loses its utility if no independent economic characterization exists, as when the purpose of a transaction is to allocate tax consequences (as in many sale-leaseback transactions), or if such reality is difficult to determine.

When a mediating term breaks down, courts look for other resolutions to the choice between formal and substantive interpretation. One such resolution looks to the pedigree of the argument, on the assumption that formal rules ordinarily favor one party over the other. When the intent of the parties to a contract is unclear, for example, a court may construe contracts *contra proferentem*,[37] against the preference of the drafter, on the assumption that form ordinarily benefits the drafter.[38]

In tax law, the one-way rule serves a mediating function comparable to that performed by *contra proferentem*. Like *contra proferentem*, the one-way rule imposes formal interpretation on the party who controls the form and therefore ordinarily benefits from such interpretation. The taxpayer, as the primary beneficiary of the certainty and restraint of formal interpretation, can hardly complain of its application to him. While adopting formal interpretation in the immediate case, the rule preserves substantive interpretation on issues the Commissioner raises.

D. *The Effect of Broader Choices on the One-Way Rule*

The choices between deference and independent judgment and formal and substantive interpretation are generally perceived as independent. In most situations, the decision to accord deference or to exercise independent judgment does not affect the choice between formal and substantive decisionmaking. In situations involving the

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36 *See, e.g.*, Gregory v. Helvering, 293 U.S. 465, 470 (1935) (finding the transaction lacking business purpose outside the reorganization provisions, notwithstanding literal compliance with the statute); Pinellas Ice & Cold Storage Co. v. Commissioner, 287 U.S. 462, 470 (1933) (reading into the reorganization provisions a requirement that the seller acquire a long-term interest in the acquiring business).

37 *See generally* RESTATEMENT (SECOND) OF CONTRACTS § 206 (1981); RESTATEMENT OF CONTRACTS § 236(d) (1932); 3 A. CORBIN, CORBIN ON CONTRACTS § 559 (1960); 4 S. WILLISTON, A TREATISE ON THE LAW OF CONTRACTS § 621 (3d ed. 1961).

38 *See* RESTATEMENT (SECOND) OF CONTRACTS § 206 comment a (1981) (the drafter is more likely to protect his own interests and to know of uncertainties in meaning).

one-way rule, however, the choices become intertwined. The one-way rule resolves the choice between formal and substantive interpretation so as to defer to the Commissioner's litigating position and to construe the tax laws liberally.

This interaction explains the mixed reaction to the rule, and situations in which it is most attractive. The one-way rule repels courts because, by liberally construing tax statutes and deferring to prior IRS action, it operates contrary to settled principles. Balancing this repulsion is the attraction the rule holds as a comfortable resolution to the choice between formal and substantive interpretation when economic reality is difficult to determine. The natural resolution of these competing pulls is that a court will appeal to the rule only when it feels uncomfortable with economic reality, which is the traditional solution to the choice between formal and substantive interpretation. Thus, the rule is most repellant when economic reality is readily ascertainable and most attractive when such reality is difficult to ascertain.

II

Rationales Offered for the One-Way Rule

A. *The Poles of Individualism and Communalism*

The rationales offered for the one-way rule reflect the tension in the law between individualism and communalism (or altruism), which constitute competing visions of justice.[39] Under the individualist position, moral imperatives are rooted in the free will of the individual, while under the communalist position, they are based on the will of the community. Because taxation derives from the will of the community, the individualist position generally resists imposing taxes, while the communalist position supports it.

These tensions do not coincide directly with the broader doctrinal choices described above. Nonetheless, each response to those choices has either an individualistic or communalistic tinge, depending upon its effect on the fisc. Strict construction, independent judgment, and formal interpretation have an individualistic tone because they generally limit taxation. In contrast, liberal construction, deference, and substantive interpretation have a

[39] *See generally* Balkin, *supra* note 13, at 13-18; Kennedy, *supra* note 26, at 1713-24. For examples of individualist and communalist arguments in judicial opinions, see Balkin, *supra* note 13, at 78-106.

communalistic flavor because they usually expand the scope of the statute.

B. Reliance on Taxpayer Volition and Systemic Utility to Justify the One-Way Rule

The poles of individualism and communalism explain the arguments offered for the one-way rule. Torn between the two visions of justice, courts invariably use both individualistic and communalistic arguments to support the rule. Reliance on both types of arguments also serves to minimize discomfort regarding the broader choices by suggesting that the one-way rule is somehow simultaneously consistent with strict and liberal construction, deference and independent judgment, and formal and substantive interpretation.

One set of arguments appeals to the taxpayer's volition: his election, choice, or bargain. This set emphasizes the taxpayer's election between equally valid tax treatments,[40] his choice of form regardless of the validity of alternative treatments,[41] and his bargain with other parties.[42] These arguments are individualistic because they find the tax liability flowing from the taxpayer's will.

The other set of arguments emphasizes the systemic need for rule: it prevents tax avoidance, provides certainty, or reduces the possibility that taxpayers will whipsaw the government.[43] This set asserts the generalized need to protect the fisc,[44] to have easily applied rules in judicial decisionmaking,[45] or to minimize revenue losses attributable to inconsistent reporting positions taken by unrelated taxpayers.[46] By emphasizing that tax liability flows from the need of the government, this set alludes to the communalistic position.

PART TWO

THE ONE-WAY RULE CONSIDERED HISTORICALLY

The preceding Part presented a static, simplified description of the one-way rule. This Part enriches that model by placing the rule in its historical context.

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[40] *See infra* notes 120-24 and accompanying text.

[41] *See infra* notes 192-99 and accompanying text.

[42] *See infra* notes 275-77 and accompanying text.

[43] "The potential for 'Whipsaw' exists whenever two (or more) taxpayers have adverse interests in the manner in which a specific item or transaction is taxed." Special Committee on Whipsaw, *supra* note 7, at 127.

[44] *See infra* notes 120-24 and accompanying text.

[45] *See infra* notes 201-02 and accompanying text.

[46] *See infra* notes 278-79 and accompanying text.

Historical analysis confirms that courts most relied on the one-way rule when economic reality was least ascertainable and that the rationales offered for the rule allude to both individualistic and communalistic positions. In addition, such analysis shows that the formulation and application of the rule varied according to the resistance to liberal construction, the sharpness in the distinction drawn between judicial and administrative authority, and the willingness to substitute consistent treatment of the parties to the transaction for inquiry into economic reality.

This Part demonstrates that the one-way rule has moved through three distinct phases, each with a characteristic time period, context, application, and rationale, summarized in Chart One.[47] Although associated with a different time period, each phase nonetheless retains vitality today. The first phase developed in the 1940s, an era in which the boundaries between agency and judicial decision were sharply demarcated. Courts forbade the taxpayer from arguing against form in a single, narrowly defined situation in which economic reality was most lacking: the recognition of gain or loss on a transfer between a shareholder and a wholly owned corporation. Elsewhere, courts freely permitted taxpayer appeals to substance. The articulated rationales for the rule, the taxpayer's election and the need to prevent tax avoidance, reflected the narrow application.

In the second phase, most closely identified with the 1950s, 1960s, and 1970s, the boundaries between deference and independent judgment became more fluid. Accordingly, the rule applied in a broader variety of situations with marginally more economic reality. During this phase, courts applied the rule inconsistently and with varying weight. Also, the rationales for the rule were broadened to encompass the taxpayer's choice and the systemic need for certainty.

Finally, in the third phase, emerging in the 1960s, 1970s, and 1980s, courts substituted transactional consistency for economic reality. As a consequence, the rule received increasing weight in a growing number of transactions between unrelated parties. Taxpayers first faced an escalated burden of proof in attacking form, and later were bound by form absent a showing that the underlying contract was unenforceable. Originally confined to determining an allocation of purchase price to a covenant not to compete, these formulations of the one-way rule extended in the 1980s to other

[47] Chart One is located on page 396.

CHART ONE

Phase	Time Period	Larger Context	Application			Rationale	
			Range	Weight	Consistency	Volitional	Systemic
One	1940s	Sharp distinctions between agency and judicial authority	Corporation/ shareholder sales	Preclusive	Yes	Election	Tax Avoidance
Two	1950-1970	Less sharp distinctions between judicial and agency authority	Entity existence; Subchapter C; Related-party transactions; Some unrelated-party transactions	Variable	No	Choice	Certainty
Three	1960-1990	Increasing emphasis on transactional consistency	Unrelated-party transactions	Strong proof; parol evidence		Bargain	Whipsaw
	(1960-1980)		Allocation to covenants not to compete		Yes		
	(1980-1990)		Other unrelated-party transactions (allocations; sales/leasebacks)		No		

unrelated-party transactions. The rationales for the rule, enforcing the parties' bargain and preventing taxpayer whipsaw of the government, reflected the loss of faith in an economic reality in unrelated-party dealings and a growing willingness to look to the transaction rather than the taxpayer before the court as the appropriate frame of reference.

The following sections describe the historical backdrop to the rule and each phase. They focus on case law discussing the one-way rule,[48] but also occasionally discuss statutes and regulations. They mention but do not dwell upon asymmetrical substantive rules, such as the limitation on capital losses, that have the effect of a one-way rule.

I

Historical Backdrop

Several long-term historical movements affected the development of the one-way rule. One such movement was the declining belief in powers absolute within their spheres. Late nineteenth century jurists viewed the judicial role as defining spheres within which actors enjoyed complete autonomy and outside of which they held no authority. As the twentieth century progressed, however, boundaries between spheres became more fluid, with more middle positions.[49]

The movement away from the idea of powers absolute within their spheres occurred at different rates in different substantive areas. The law of personal jurisdiction provides one striking example of the movement. Late in the nineteenth century, courts saw personal jurisdiction in on/off terms, as being either present or absent, depending on the defendant's location.[50] In the twentieth century, however, jurisdiction became an issue of policy as much as power, as a weighing of interests analysis supplanted rules looking solely to the defendant's location.[51]

A parallel development occurred in conflicts of laws. Early in the

[48] Therefore, they do not discuss such classics of form-over-substance as Commissioner v. Court Holding Co., 324 U.S. 331 (1945), and Gregory v. Helvering, 293 U.S. 465 (1935), which involved government challenges to form.

[49] *See* Mensch, *The History of Mainstream Legal Thought*, in The Politics of Law 13 (D. Kairys ed. 1990).

[50] *See* Pennoyer v. Neff, 95 U.S. 714, 733-34 (1877) (in personam jurisdiction exists only if the defendant is present in the forum).

[51] *See* International Shoe Co. v. Washington, 326 U.S. 310, 316 (1945) (in personam jurisdiction exists if the defendant has certain minimum contacts with the forum such that bringing an action will not offend ideas of "fair play and substantial justice").

twentieth century, courts chose applicable law by looking to the location of the tort, contract, marriage, incorporation, or property.[52] Later in the century, however, courts engaged in interest analysis.[53]

A second long-term movement was the severance of tax law from administrative law. Over the course of the twentieth century, specialization within the legal profession caused tax law to be regarded as an independent field. Administrative law texts evidence this severing. Early twentieth century administrative law casebooks commonly devoted considerable attention to taxation.[54] Later works give taxation less discussion.[55]

A third movement was the increasing judicial sympathy to tax law. Late nineteenth century jurists were commonly hostile to legislation in general,[56] and taxation in particular. In the twentieth

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52 *See, e.g.*, 2 J. BEALE, THE CONFLICT OF LAWS (1935); RESTATEMENT OF CONFLICT OF LAWS (1934).

53 *See, e.g.*, Haag v. Barnes, 9 N.Y.2d 554, 175 N.E.2d 441, 216 N.Y.S.2d 65 (1961); Auten v. Auten, 308 N.Y. 155, 124 N.E.2d 99 (1954); RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 6 comment c (1971) (reliance of "most significant relationship" test on factors other than location).

54 *See, e.g.*, F. FRANKFURTER & J. DAVISON, CASES AND MATERIALS ON ADMINISTRATIVE LAW 488-520 (2d ed. 1935) (chapter on taxation); E. FREUND, CASES ON ADMINISTRATIVE LAW 107-37, 557-71 (2d ed. 1928) (chapters on revenue administration); M. KATZ, CASES AND MATERIALS ON ADMINISTRATIVE LAW (1947) (substantial discussion of IRC and IRS); R. MAURER, CASES AND OTHER MATERIALS ON ADMINISTRATIVE LAW 198-200, 222-26 (1937) (discussion of treasury regulations and the Board of Tax Appeals); K. SEARS, CASES AND MATERIALS ON ADMINISTRATIVE LAW 313-95 (1938) (chapter on taxation).

55 Income taxation receives scant attention in S. BREYER & R. STEWART, ADMINISTRATIVE LAW AND REGULATORY POLICY (2d ed. 1985); W. GELLHORN & C. BYSE, ADMINISTRATIVE LAW: CASES AND COMMENTS (1960); L. JAFFE, ADMINISTRATIVE LAW: CASES AND MATERIALS (1954); G. ROBINSON & E. GELLHORN, THE ADMINISTRATIVE PROCESS (1974); B. SCHWARTZ, ADMINISTRATIVE LAW (2d ed. 1984). In addition, the attention devoted to taxation in one series of texts decreased in successive editions. *Compare* C. MCFARLAND & A. VANDERBILT, CASES AND MATERIALS ON ADMINISTRATIVE LAW 1048 (1947) (numerous references to "tax administration" in index) *with* C. MCFARLAND & A. VANDERBILT, CASES AND MATERIALS ON ADMINISTRATIVE LAW 873 (2d ed. 1952) (single reference to "tax administration" in index); *compare also* W. GELLHORN, ADMINISTRATIVE LAW: CASES AND COMMENTS 1006 (1940) (several references to taxes in index) *with* W. GELLHORN, ADMINISTRATIVE LAW: CASES AND COMMENTS 1137 (1947) (single reference to taxes in index).

The transition of the Tax Court from an independent agency within the executive branch to an article I court provides another illustration of tax law's severance from administrative law during this century. *See* 1 K. DAVIS, ADMINISTRATIVE LAW TREATISE 1 n.2 (1958).

56 *See* J. HURST, DEALING WITH STATUTES 11-12 (1982); Pound, *Common Law and Legislation*, 21 HARV. L. REV. 383, 386 (1908).

century, this attitude reversed.[57] For example, in 1895, the Supreme Court struck down the income tax as a prohibited direct tax,[58] and twenty-five years later relied upon that prohibition to exclude a pro rata stock dividend from the definition of income.[59] By mid-century, however, the prohibition on direct taxation ceased playing a significant role in income tax cases.[60]

The decline of the rule requiring that tax statutes be strictly construed against the government also illustrates the growing judicial sympathy for taxation.[61] Once "founded so firmly . . . as not to admit reasonable doubt,"[62] this maxim lost its following over the twentieth century.[63] The Supreme Court adopted the strict construction rule of tax statutes in 1917, only to repudiate it twenty-one years later.[64]

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[57] *See generally* Jones, *Class Tax to Mass Tax: The Role of Propaganda In The Expansion of the Income Tax During World War II*, 37 BUFFALO L. REV. 685 (1989).

[58] *See* Pollack v. Farmers' Loan & Trust Co., 157 U.S. 429, *modified*, 158 U.S. 601 (1895), *overruled*, South Carolina v. Baker, 485 U.S. 505 (1988).

[59] Eisner v. Macomber, 252 U.S. 189 (1920).

[60] *See* 1 B. BITTKER & L. LOKKEN, *supra* note 3, at 1-26 ("In later cases, the judiciary has bowed to legislative decisions regarding the term 'income,' and the direct tax clause of the Constitution has never again had the power that was attributed to it by *Pollack v. Farmers' Loan & Trust Co.* and *Eisner v. Macomber*." (citation omitted)).

[61] *See* 1 J. MERTENS, THE LAW OF FEDERAL INCOME TAXATION § 3.31 (1990) (describing declining reliance on the rule requiring that courts resolve doubts in taxpayer's favor).

[62] Cahoon v. Coe, 57 N.H. 556, 570 (1876).

[63] *See* 1 B. BITTKER & L. LOKKEN, *supra* note 3, ¶ 4.3.1.

Successive editions of Sutherland's STATUTES AND STATUTORY CONSTRUCTION paid progressively more attention to alternatives to strict construction. *See* J. SUTHERLAND, STATUTES AND STATUTORY CONSTRUCTION 462 (1891) (describing only the rule requiring that tax statutes receive narrow construction); 2 J. SUTHERLAND, STATUTES AND STATUTORY CONSTRUCTION 999 (J. Lewis 2d ed. 1904) (adding that some courts require tax statutes be liberally construed); 3 J. SUTHERLAND, STATUTES AND STATUTORY CONSTRUCTION 293-99 (F. Horack ed. 1943) (describing both the general rule requiring strict construction of statutes and the rule favoring reasonable construction of statutes); 3A J. SUTHERLAND, STATUTES AND STATUTORY CONSTRUCTION § 66.02 (N. Singer 4th ed. 1986) (expanded and more prominent discussion of the rule requiring reasonable construction).

[64] *Compare* Gould v. Gould, 245 U.S. 151, 153 (1917) ("In case of doubt, [tax statutes] are [to be] construed most strongly against the Government, and in favor of the [taxpayer].") *with* White v. United States, 305 U.S. 281, 292 (1938) ("We are not impressed by the argument that . . . all doubts should be resolved in favor of the taxpayer."). *See also* Griswold, *supra* note 17, at 1142-43.

II

PHASE ONE: THE ONE-WAY RULE GIVEN CONCLUSIVE WEIGHT BASED ON THEORIES OF ELECTION AND TAX AVOIDANCE

During phase one, occurring in the 1940s, courts applied the one-way rule by referring to sharply demarcated spheres of power. Accordingly, the one-way rule received preclusive effect in a narrow set of situations in which economic reality was least discernable.

A. *Belief in Powers Absolute Within Their Spheres*

In the 1940s, the notion of powers absolute within their spheres dominated administrative law. Agency authority was viewed in on/off terms. Under the "delegation" doctrine then prevalent, constitutionally legislative issues simply could not be delegated to agencies.[65] Underlying this doctrine was the belief that statutes were sources of positive law that courts alone could interpret.[66]

The theory of powers absolute within their spheres defined the relationship between agency and judicial decisionmaking by assigning agency and court separate, sharply distinguished realms over which each held primacy. The weight given an agency decision was then determined by categorizing the immediate issue at hand. In the 1940s, courts allocated authority by asking whether the agency determination fell within the scope of the statute.[67] Agency determinations within the scope of the statute received controlling weight if reasonable; those outside the scope of a statute received no special weight. Two Supreme Court cases described these realms.

The realm of agency dominance was described in *Gray v. Powell*,[68] in which the Supreme Court sustained[69] the National Bitumi-

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[65] *See, e.g.*, Schecter Poultry Corp. v. United States, 295 U.S. 495 (1935); Panama Ref. Co. v. Ryan, 293 U.S. 388 (1935).

[66] *See* Diver, *supra* note 19, at 569; Frug, *The Ideology of Bureaucracy in American Law*, 97 HARV. L. REV. 1276, 1300-05 (1984) (describing formalism in administrative law and its relationship to the delegation doctrine).

[67] Prior to the 1940s, the two realms were issues of fact, over which agencies had primary responsibility, and issues of law, over which courts exercised independent judgment. *See generally* L. JAFFE, JUDICIAL CONTROL OF ADMINISTRATIVE ACTION 546 n.3 (1965); Brown, *Fact and Law in Judicial Review*, 56 HARV. L. REV. 899 (1943); Stern, *Review of Findings of Administrators, Judges and Juries: A Comparative Analysis*, 58 HARV. L. REV. 70 (1944).

[68] 314 U.S. 402 (1941).

[69] *Id.* at 412.

nous Coal Commission's determination that a leasing arrangement for producing coal did not make the lessor a "producer," exempt from the Bituminous Coal Act.[70] In so holding, the Court found that the agency had made a reasonable determination within its administrative routine:

> In a matter left specifically by Congress to the determination of an administrative body, . . . the function of review placed upon the courts . . . is fully performed when they determine that there has been a fair hearing, with notice and an opportunity to present the circumstances and arguments to the decisive body, and an application of the statute in a just and reasoned manner.
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> Such a determination as is here involved belongs to the usual administrative routine. Congress, which could have legislated specifically as to the individual exemptions from the code, found it more efficient to delegate that function to those whose experience in a particular field gave promise of a better informed, more equitable, adjustment of the conflicting interests of price stabilization upon the one hand and producer consumption upon the other.
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> . . . .
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> Where, as here, a determination has been left to an administrative body, this delegation will be respected and the administrative conclusion left untouched. Certainly, a finding on Congressional reference that an admittedly constitutional act is applicable to a particular situation does not require such further scrutiny.
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> . . . .
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> . . . Unless we can say that a set of circumstances deemed by the Commission to bring them within the concept 'producer' is so unrelated to the tasks entrusted by Congress to the Commission as in effect to deny a sensible exercise of judgment, it is the Court's duty to leave the Commission's judgment undisturbed.[71]

Five years later, in *Social Security Board v. Nierotko*,[72] the Supreme Court described the realm of judicial primacy. The Court reversed the Social Security Board's determination that back pay did not constitute "wages" under the Social Security Act, explaining that such determination was outside the administrative routine and therefore subject to independent judicial review:

> Administrative determinations must have a basis in law and must be within the granted authority. Administration, when it interprets a statute so as to make it apply to particular circumstances,

[70] Bituminous Coal Act of 1937, 50 Stat. 72 (1937) (codified at 15 U.S.C. §§ 828-852 (1940) (repealed 1966). Section 833(1) of the Act exempted "coal consumed by a producer [and] coal transported by the producer to himself for consumption by him."

[71] *Gray*, 314 U.S. at 411-13 (citations omitted); *see also* NLRB v. Hearst Publications, Inc., 322 U.S. 111, 130 (1944).

[72] 327 U.S. 358 (1946).

> acts as a delegate to the legislative power. Congress might have declared that "back pay" awards under the Labor Act should or should not be treated as wages. Congress might have delegated to the Social Security Board to determine what compensation paid by employers to employees should be treated as wages. Except as such interpretive power may be included in the agencies' administrative functions, Congress did neither. An agency may not finally decide the limits of its statutory power. That is a judicial function.
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> . . . .
>
> We conclude, however, that the Board's interpretation of this statute to exclude back pay goes beyond the boundaries of administrative routine and the statutory limits. This is a ruling which excludes from the ambit of the Social Security Act payments which we think were included by Congress. It is beyond the permissible limits of administrative interpretation.[73]

Likewise, the Supreme Court viewed the one-way rule as creating sharp distinctions that allocated authority between court and agency. Indeed, the Court paired *Gray* and *Nierotko* with the two leading one-way rule cases of the period: *Higgins v. Smith*,[74] which formulated the rule, and *Bartels v. Birmingham*,[75] which rejected it. Read together, these four cases reveal that the Court viewed the one-way rule as carving out a sharply defined sphere over which the IRS exercised unfettered authority.

Adoption of the one-way rule was associated with deference to IRS interpretation. Thus, the Court associated *Higgins* with *Gray*. *Gray* cited *Higgins* for the proposition that "[t]he choice of disregarding a deliberately chosen arrangement for conducting business affairs does not lie with the creator of the plan."[76] Furthermore, Justice Douglas, who in the 1940s was relatively deferential to administrative agencies,[77] dissented in *Bartels* and appealed to *Gray* as authority for the *Higgins* one-way rule.[78]

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73 *Id.* at 369-70; *see also* NLRB v. Highland Park Mfg. Co., 341 U.S. 322, 326 (1951) ("[A]n issue of law . . . which goes to the heart of the validity of the proceedings on which the order is based, is open to inquiry by the courts . . . .").

74 308 U.S. 473 (1940).

75 332 U.S. 126 (1947).

76 *Gray*, 314 U.S. at 414 (citing *Higgins*, 308 U.S. at 477).

77 *See* Wolfman, Silver & Silver, *The Behavior of Justice Douglas in Federal Tax Cases*, 122 U. PA. L. REV. 235, 315-20 (1973) (linking Douglas' views in tax cases with his attitudes toward administrative agencies).

78 Justice Douglas wrote:

> I think the tax collector should be entitled to take such private arrangements at their face. In other situations a taxpayer may not escape the tax consequences of the business arrangements which he makes on the grounds that they are fictional. The Government may 'sustain or disregard the effect of

Conversely, the Court equated rejection of the one-way rule with the exercise of independent judgment. Accordingly, the Court paired *Bartels*, which rejected the rule, with *Nierotko* and its affirmation of independent judgment. In refusing to accede to the IRS's litigating position, which followed a published ruling,[79] the *Bartels* Court cited *Nierotko* and concluded: "We are of the opinion that such administrative action [the IRS ruling] goes beyond routine and exceeds the statutory power of the Commissioner."[80]

B. *Preclusive and Consistent Application of the One-Way Rule to Sales Between Corporation and Shareholder*

Viewing the one-way rule as creating a sphere of IRS autonomy in a system in which such autonomy was generally absent, courts used the rule sparingly but with great effect. Thus, the rule received preclusive, consistent application in the limited set of situations in which economic reality was most doubtful. Elsewhere, it had no application.

The core case for applying the rule was in characterizing sales between related corporations. *Higgins* itself considered whether a shareholder recognized a loss upon the sale of property to a wholly owned corporation.[81] In concluding that he did not, the Court needed to distinguish *Burnet v. Commonwealth Improvement Co.*,[82] which had held that a shareholder recognized gain upon such a sale. The sole distinction offered by Justice Reed, the author of the opinion, was that in *Burnet*, the taxpayer challenged the form of the transaction.[83]

> the fiction as best serves the purposes of the tax statute.' That rule is not restricted in its application to the use by taxpayers of corporate or related devices to obtain tax advantages. It was applied in *Gray v. Powell* where a railroad sought exemption from the Bituminous Coal Act by contending that the operations of one who appeared to be an independent contractor were in fact its operations. The Court in rejecting the contention said that 'The choice of disregarding a deliberately chosen arrangement for conducting business affairs does not lie with the creator of the plan.' I see no reason for creating an exception to that rule here. If the Government chooses to accept the contract on its face, the parties should be barred from showing that it conceals the real arrangement. Tax administration should not be so easily embarrassed.

Bartels, 332 U.S. at 133 (Douglas, J., dissenting) (citing *Higgins*, 308 U.S. at 477; *Gray*, 314 U.S. at 414).

79 *See* 1944-5-11651, Mim. 5638, 1944 C.B. 547; 1944-22-11889, Mim. 5767, 1944 C.B. 548.

80 *Bartels*, 332 U.S. at 132.

81 *Higgins*, 308 U.S. 473.

82 287 U.S. 415 (1932).

83 *Higgins*, 308 U.S. at 477.

In justifying this holding, Justice Reed emphasized the difficulty of determining the economic reality of related-party sales. He noted that because a wholly owned corporation and its shareholder are ultimately one, the transaction could be regarded as a transfer between the shareholder's left and right hands.[84] Alternatively, he acknowledged that because the law generally recognizes a corporation as separate and apart from its shareholders, the transaction could be characterized as giving rise to a sale.[85] Justice Reed also expressed doubt about the transaction's economic reality when he described the taxpayer as making an irrevocable "election" to do business as a corporation,[86] comparable to choosing an accounting method[87] or filing a joint return.[88] Because a binding election can be made only when each alternative receives legal sanction,[89] this analogy suggested that both recognition and nonrecognition were somehow "correct."

Justice Reed's views regarding economic reality were undoubtedly influenced by legislation enacted after the sale at issue in *Higgins*. By the time of the Court's decision, Congress had already acted prospectively to disallow losses on sales between wholly owned corporations and their shareholders.[90] This legislative deter-

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[84] *Id.* at 475.

[85] *Id.* at 476.

[86] *Id.* at 477.

[87] *See, e.g.*, I.R.C. § 446 (1991).

[88] *See, e.g.*, I.R.C. § 6013 (1991).

[89] For example, in Thompson-King-Tate, Inc. v. United States, 296 F.2d 290, 294 (6th Cir. 1961), the court stated:

> We recognize that where a taxpayer is authorized under the income tax statutes to treat income from a transaction in either of two ways, his election to treat it in one of those ways is binding upon him. But the principle of election does not apply where the taxpayer has no legal opportunity to choose. If, under the statutes, income must be reported in a certain way and the taxpayer erroneously reports it in a different way, such treatment is not binding upon either the taxpayer or the Commissioner.

In Le Bolt & Co. v. United States, 67 Ct. Cl. 422, 426 (1929), the court held:

> The weight of authority is to the effect that where there are two methods of making an income tax return, either one of which is legal and proper, and the taxpayer has made his return in accordance with one of these methods, then, if the return is accepted and taxes paid accordingly, the taxpayer can not subsequently change to the other method of making a return and thereby become entitled to a refund. But if there is only one legal and proper method of making a return and the taxpayer erroneously makes his return by some other method, then, even though the return has been accepted and the taxes paid, he may file an amended return correcting the error, and if this return shows an overpayment, he becomes entitled to a refund.

[90] 48 Stat. 691 (1934) (current version at I.R.C. § 267 (1991)).

mination made it easy for Justice Reed to dismiss the sale as lacking in reality.

A second important source of the one-way rule during phase one was section 45 (now section 482) of the Code, which allowed the Commissioner, but not the taxpayer, to allocate income, deductions, credits, or allowances between related corporations.[91] Like *Higgins*, section 45 dealt with the tax consequences of sales among related corporations. Furthermore, like the rule adopted in *Higgins*, section 45 precluded the taxpayer from arguing against the form of the transaction, on the congressionally sanctioned assumption that such transactions lack economic reality.[92] The close kinship of *Higgins* and section 45 is evident in case law relying upon *Higgins* to interpret that section.[93]

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[91] In any case of two or more organizations, trades, or businesses . . . owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any such organizations, trades, or businesses.

I.R.C. § 482 (1991).

[92] Despite some room for argument, it has always been clear that section 45 is a one-way rule. *See* Cooper, *Section 45*, 4 TAX L. REV. 131, 162-66 (1949). For a more recent statement of this position, see Treas. Reg. § 1.482-1(b)(3) (1990) ("Section 482 grants no right to a controlled taxpayer to apply its provisions at will, nor does it grant any right to compel the district director to apply such provisions.").

[93] *See* Advance Mach. Exch., Inc. v. Commissioner, 196 F.2d 1006, 1008 (2d Cir.) (refusing to allow taxpayer to disregard controlled corporations), *cert. denied*, 344 U.S. 835 (1952). For later application of *Higgins* to sales between related corporations, see Sterno Sales Corp. v. Commissioner, 345 F.2d 552, 554 (Ct. Cl. 1965) (applying one-way rule to characterization of payment between brother-sister corporations).

This explanation of the rule may also shed light on the limitation on capital losses, I.R.C. § 1211 (1991) (limiting deduction of capital losses by corporations and individuals), and the "wash" sale rule, I.R.C. § 1091 (1991) (deferring loss from sale of securities if taxpayer acquires substantially similar securities within thirty days). If economic reality is equated with the Haig-Simons definition of income, *see supra* note 34 and accompanying text, and the realization requirement with a formality that deviates from this norm, these rules serve as one-way rules. In gain transactions, the taxpayer is bound to his form and pays tax on the full amount of his realized gains; in loss transactions, however, the taxpayer is denied full deduction despite realization. Otherwise, the taxpayer could manipulate his realizations by selectively selling assets that give rise to a loss. Interestingly, in enacting those rules, Congress expressed its concern for the underlying economic reality. *See* H.R. REP. NO. 1388, 67th Cong., 4th Sess. 2-3 (1923) (describing capital losses as frequently nothing more than paper losses) H.R. REP. NO. 350, 67th Cong., 1st Sess. 10 (1921) (describing wash sales as fictitious exchanges).

C. *Refusal to Extend the One-Way Rule Beyond Related-Party Sales*

In *Higgins*, the one-way rule lacked limitation. In succeeding years, however, the Court confined the *Higgins* rule to a narrow fact pattern: related-party sales. The Supreme Court refused to apply the rule to situations in which the Code or other bodies of law defined economic reality. Thus, the Court refused to apply the one-way rule in three situations: recognition of an entity as a separate taxpayer, tax treatment of corporate distributions and adjustments, and characterization of transactions among unrelated parties.

1. *Recognition of Corporation as a Separate Taxpayer*

On its face, *Higgins* seemingly estopped the taxpayer from ever asserting that the reality of an entity differed from its form. Nonetheless, applying *Higgins* was difficult when the issue was whether a corporation would be recognized as a separate taxpayer subject to corporate income tax. After all, the corporate tax is premised on the assumption that corporations have economic reality. Congress assumed that a corporation had independent reality and enacted a tax on its income.[94]

Thus, when the issue of corporate existence was raised in *Moline Properties, Inc. v. Commissioner*,[95] Justice Reed stated that a corporation would be recognized so long as its "purpose is the equivalent of business activity or is followed by the carrying on of business."[96] This test allowed the taxpayer as well as the Commissioner to raise the issue of corporate existence. Justice Reed distinguished *Higgins* as involving "a sham or unreal" corporation and asserted that "[i]n such situations the form is a bald and mischievous fiction."[97] The Court also adopted this distinction in *National Carbide Corp. v. Commissioner*,[98] in which the taxpayer was allowed to argue that the corporation acted simply as an agent and was not taxable on income it received.

Justice Reed's purported distinction of *Higgins* was disingenuous;

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94 Congress' decision may have been necessitated by court decisions striking down income taxes that ignored corporate existence; *see* Mundstock, *Taxation of Intercorporate Dividends Under an Unintegrated Regime*, 44 TAX L. REV. 1, 5-6 (1988).

95 319 U.S. 436 (1943).

96 *Id*. at 439.

97 *Id*. For a similar reading of *Higgins*, see Commissioner v. Laughton, 113 F.2d 103, 104 (9th Cir. 1940) (*Higgins* limited to sham transactions).

98 336 U.S. 422, 437 n.20 (1949) ("[E]ven a corporation which satisfies the usual tests of agency may be disregarded by the Commissioner if it is a sham or unreal.").

Higgins conceded that a corporation existed.[99] In fact, *Moline Properties* and *National Carbide* significantly curtailed *Higgins*.[100]

This curtailment of *Higgins* is evident in three opinions authored by Judge Learned Hand in the 1940s. In *United States v. Morris & Essex Railroad*,[101] Judge Hand held that a corporation that leased all its property to outsiders was taxable on the payments made directly by the outsiders to the shareholders, relying on *Higgins* to dismiss the taxpayer's argument that the corporation did not constitute a separate taxpayer.[102] After the Supreme Court's decision in *Moline Properties*, however, Judge Hand acknowledged error in *National Investors Corp. v. Hoey*[103] and permitted a taxpayer to challenge an assessment of corporate income tax on the ground that no corporation existed.[104] Finally, in *Commissioner v. National Carbide Corp.*,[105] he recognized the weakness of Justice Reed's distinction by venturing that *Higgins* might "make it possible for the Treasury at times to disregard transactions between . . . shareholders and [a] corporation even though it be a 'corporation' [because it conducts business] although it must be confessed that the differentia is left open."[106]

2. *Corporate Distributions and Adjustments*

The "election" underlying *Higgins* did not exist for issues involving the taxation of corporate distributions and adjustments, now found in Subchapter C of the Code.[107] Those rules do not yield

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99 It is clear an actual corporation existed. Numerous transactions were carried on by it over a period of years. It paid taxes, state and national, franchise and income. But the existence of an actual corporation is only one incident necessary to complete an actual sale to it under the revenue act.

Higgins v. Smith, 308 U.S. 473, 476 (1940).

100 *Moline Properties*, 319 U.S. at 438-41; *National Carbide*, 336 U.S. at 437.

101 135 F.2d 711 (2d Cir.), *cert. denied*, 320 U.S. 754 (1943).

102 *Id*. at 713 ("[T]he Treasury may take a taxpayer at his word, so to say; when that serves its purpose, it may treat his corporation as a different person from himself; but that is a rule which works only in the Treasury's own favor; it cannot be used to deplete the revenue.").

103 144 F.2d 466 (2d Cir. 1944).

104 *Id*. at 467 ("[W]e were wrong [in *Morris & Essex*]; we neglected to observe that the corporate 'form' must be 'unreal or a sham,' before the Treasury may disregard it; we had taken too literally the concluding language that it was the 'command of income and its benefits which marks the real owner of property.' ").

105 167 F.2d 304 (2d Cir. 1948), *aff'd*, 336 U.S. 422 (1949).

106 *Id*. at 307. For further discussion of Judge Hand's views of *Higgins*, see Chirelstein, *Learned Hand's Contribution to the Law of Tax Avoidance*, 77 YALE L.J. 440, 447-52 (1968).

107 I.R.C. §§ 301-86 (1991).

different results depending upon whether a corporation exists. They presume that a corporation exists and prescribe the means for making various characterizations as, for example, whether a distribution is a redemption or not.[108] The legislative attention given such characterizations made it difficult for courts to assume blithely that they lacked economic reality. Accordingly, these determinations were less fertile ground for the one-way rule.

Both before and after *Higgins*, the Court allowed taxpayers to challenge the form of a transaction when arguing for special treatment under Subchapter C. Three years prior to *Higgins*, the Court permitted a taxpayer to prove that, contrary to its form, a transaction in substance constituted a tax-free reorganization.[109] The Court characterized the transaction "by what in fact was done rather than by the mere form of words used in the writings employed,"[110] and determined whether a cash payment was in fact made by the acquiring corporation or its shareholders.

After *Higgins*, the Court continued to allow taxpayers to argue that a particular transaction in fact qualified as a reorganization. In *Helvering v. Alabama Asphaltic Limestone Co.*,[111] the Court held that a transaction qualified as a reorganization even though the transferred properties were owned by the creditors' committee (rather than by the merged corporation). The Court dismissed such ownership as adding "nothing of substance to the completed affair" and as constituting a mere intermediate device.[112]

3. *Unrelated-Party Transactions*

The *Higgins* one-way rule was not applied to transactions among unrelated parties. The lack of relationship among the parties made it likely that economic reality coincided with the form of the agreement. Moreover, when they did not coincide, economic reality could be determined by reference to other, well-established bodies of law. Thus, the Court allowed the taxpayer and Commissioner alike to appeal to economic reality.

One month before deciding *Higgins*, the Court in *Helvering v. F.& R. Lazarus & Co.*[113] held that a nominal lessee could depreciate property leased in a sale-leaseback transaction because the transac-

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108 *See* I.R.C. § 302 (1991).
109 *See* Helvering v. Tex-Penn Oil Co., 300 U.S. 481 (1937).
110 *Id.* at 493 (citations omitted).
111 315 U.S. 179 (1942).
112 *Id.* at 185.
113 308 U.S. 252 (1939).

tion was in reality a mere security device.[114] In so holding, the Court relied on a long line of authority treating a deed executed as security for a loan as an equitable mortgage.[115]

The Court squarely addressed *Higgins'* application to unrelated-party transactions in *Bartels v. Birmingham*,[116] which considered whether band leaders engaged to play in dance halls were responsible for paying employment taxes. This depended upon whether the band leaders were employees or independent contractors. Conceding that general principles made the band leaders independent contractors, the IRS nonetheless ruled that the standard industry contract rendered them employees.[117] The Court rejected the ruling:

> The argument of respondents to support the administrative interpretation of the regulations is that the Government may accept the voluntary contractual arrangements of the amusement operators and entertainers to shift the tax burden from the band leaders to the operators. Cases [including *Higgins*] are cited to support this position. All of these cases, however, involve the problem of corporate or association entity. They are not pertinent upon the question of contracts to shift tax liability from one taxpayer to another wholly distinct and disconnected corporation or individual. We do not think that such a contractual shift authorizes the Commissioner to collect taxes from one not covered by the taxing statute.[118]

In determining economic reality, the Court drew upon precedent interpreting "employee" in the National Labor Relations Act.[119]

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[114] *Id.* at 255. ("In the field of taxation, administrators of the laws, and the courts, are concerned with substance and realities, and formal written documents are not rigidly binding.")

[115] *Id.* at 255 & n.8; *see also* 1 B. BITTKER & L. LOKKEN, *supra* note 3, ¶ 4.4.6 (noting long common law tradition, rooted in prohibitions on usury, permitting taxpayers to establish that a sale-leaseback was a mortgage); 2 B. BITTKER, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 40.6.2 (1981); Cunningham & Tischler, *Disguised Real Estate Security Transactions as Mortgages in Substance*, 26 RUTGERS L. REV. 1 (1972).

[116] 332 U.S. 126 (1947).

[117] *Id.* at 131.

[118] *Id.* at 131-32 (footnotes omitted). For a similar, more recent reading of *Higgins*, see Cottage Savings Ass'n v. Commissioner, 111 S. Ct. 1503, 1512 (1991) (distinguishing *Higgins* as involving sales that were not at arm's length and in which the seller retained ownership of the sold property through a wholly owned corporation).

[119] 29 U.S.C. §§ 151-169 (1991). The Court relied on United States v. Silk, 331 U.S. 704 (1947), which, in interpreting the Social Security Act, had looked to the National Labor Relations Act to differentiate an "employee" from an "independent contractor." *Id.* at 713-14.

D. *Rationales for the One-Way Rule: Election and Tax Avoidance*

The rationales used to justify the one-way rule during phase one reflected its narrow range. These rationales are implicit in Justice Reed's discussion of *Burnet v. Commonwealth Improvement Co.*[120] in *Higgins*:

> In the *Commonwealth Improvement Company* case, the taxpayer, for reasons satisfactory to itself voluntarily had chosen to employ the corporation in its operations. A taxpayer is free to adopt such organization for his affairs as he may choose and having elected to do some business as a corporation, he must accept the tax disadvantages.
>
> On the other hand, the Government may not be required to acquiesce in the taxpayer's election of that form for doing business which is most advantageous to him. The Government may look at actualities and upon determination that the form employed for doing business or carrying out the challenged tax event is unreal or a sham may sustain or disregard the effect of the fiction as best serves the purposes of the tax statute. To hold otherwise would permit the schemes of taxpayers to supersede legislation in the determination of the time and manner of taxation. It is command of income and its benefits which marks the real owner of property.[121]

Subsumed in this discussion are two rationales for the one-way rule. One is the taxpayer's volition, his election. This rationale alludes to the doctrine of election, which prevents taxpayers from revoking elections.[122] The second rationale is the systemic function of the rule: its elimination of taxpayer "schemes." This rationale was supported by citing cases in which the Court struck down tax avoidance schemes,[123] a line in which commentators placed *Higgins*.[124]

Both rationales suggest a narrow scope for the rule. The doctrine

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120 287 U.S. 415 (1932).

121 Higgins v. Smith, 308 U.S. 473, 477-78 (1940) (footnotes omitted).

122 *See supra* note 86 and accompanying text.

123 *Higgins*, 308 U.S. at 478 n.11. These cases were Lucas v. Earl, 281 U.S. 111 (1930) (wage earner taxed on salary despite anticipatory assignment of wages); Corliss v. Bowers, 281 U.S. 376 (1930) (income of revocable trust taxed to the grantor); Griffiths v. Commissioner, 308 U.S. 355 (1939) (seller cannot avoid tax consequences of sale by interposing intermediary corporation).

124 Contemporary commentators believed that tax avoidance concerns motivated the result in *Higgins*. *See* Rudick, *The Problem of Personal Income Tax Avoidance*, 7 LAW & CONTEMP. PROBS. 243, 257-58 (1940); Surrey, *The Supreme Court and the Federal Income Tax: Some Implications of the Recent Decisions*, 35 U. ILL. L. REV. 779, 803 (1941).

of election implies a narrow scope because it applies only in limited, usually legislatively sanctioned, situations. For an election to occur, the chosen characterization and alternative characterizations both must be permissible,[125] and an unequivocal representation must be made to the IRS, generally on a tax return.[126] Thus, an election rarely occurs. To call a choice of business entity an "election" is to stretch considerably the doctrine of election.

Likewise, tax avoidance suggests narrow application for the one-way rule. The notion that the intent to avoid taxes can, standing alone, justify imposing a tax is highly controversial.[127] Professors Bittker and Lokken, for example, argue that, at most, such intent influences a court in a borderline situation.[128] The shakiness of this foundation reflected the narrow role accorded the one-way rule.

III

PHASE TWO: UNCERTAIN APPLICATION OF THE ONE-WAY RULE BASED ON THE THEORIES OF CHOICE AND CERTAINTY

A. *The Collapse of Sharply Demarcated Spheres*

From 1950 to 1970, courts extended the one-way rule outside its previous narrow confines. In part, this extension may have resulted from the severance of tax from administrative law.[129] After the 1940s, courts seldom overtly equated the one-way rule with deference to agencies.

Moreover, even in administrative law, the notion of powers absolute in their spheres diminished in importance. As the delegation doctrine lost vitality, agency authority became less of an on/off issue.[130] Viewing statutes less often as sources of positive law, courts

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[125] *See supra* note 89 and accompanying text.

[126] *See* J. E. Riley Inv. Co. v. Commissioner, 311 U.S. 55, 59 (1940); Pacific Nat'l Co. v. Welch, 304 U.S. 191, 194 (1938). *See generally*, Maguire & Zimet, *Hobson's Choice and Similar Practices in Federal Taxation*, 48 HARV. L. REV. 1281, 1281-93 (1935) (discussing election in federal tax law).

[127] *See, e.g.*, Superior Oil Co. v. Mississippi, 280 U.S. 390, 395-96 (1930) ("The fact that [the taxpayer] desired to evade the law . . . is immaterial, because the very meaning of a line in the law is that you may go as close to it as you can if you do not pass it."); Helvering v. Gregory, 69 F.2d 809, 810 (2d Cir. 1934) ("Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury . . . ."), *aff'd*, 293 U.S. 465 (1935); *see also* 1 B. BITTKER & L. LOKKEN, *supra* note 3, at 4-29 to 4-30.

[128] *See* 1 B. BITTKER & L. LOKKEN, *supra* note 3, at 4-31.

[129] *See supra* notes 54-55 and accompanying text.

[130] After Yakus v. United States, 321 U.S. 414 (1944), the delegation doctrine lost

were more accepting of agencies' authority to interpret law.[131] As Professor Kenneth Culp Davis has observed, there was a movement away from sharp distinctions in the allocation of authority between court and agency that began in the 1950s,[132] and continued into the 1980s,[133] culminating in the Supreme Court's decision in *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*[134] As a result, the relationship between agency and judicial determinations became less certain in two respects.

First, deference to agency determinations was less rigorously confined to determinations within the scope of the statute. Courts increasingly described agency and judicial interpretations of statutes as occupying a common domain in which agency interpretations were accorded weight, rather than a presumption of correctness if

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force. *See* Aranson, Gellhorn, & Robinson, *A Theory of Legislative Delegation*, 68 CORNELL L. REV. 1, 12 (1982) (delegation doctrine called "nondoctrine"); Schwartz, *Of Administrators and Philosopher-Kings: The Republic, the Laws, and Delegations of Power*, 72 NW. U.L. REV. 443, 446 (1977) (describing delegation doctrine as "virtually shorn of practical meaning").

[131] *See* B. SCHWARTZ, *supra* note 55, at 24 (describing the consistent narrowing of judicial review of agency decisions over the course of the twentieth century); Diver, *supra* note 19, at 569; Kmiec, *Judicial Deference to Executive Agencies and the Decline of the Nondelegation Doctrine*, 2 ADMIN. L.J. 269, 286 (1988) ("If expansive delegations of legislative authority are permissible, interpretations made in pursuit of that authority merit judicial deference.").

[132] [T]he movement clearly has been away from sharp distinctions between what is reasonable and what is correct, between the rational and the right, between what is within the area for administrative discretion and what is the proper interpretation of the statute or other law. Whereas in the 1950s those distinctions often seemed to be the basis for judicial reasoning as to the proper scope of review, in the 1970s those distinctions still enter into judicial rhetoric and occasionally seem to affect the reasoning but no longer are generally the central factor around which all other factors concerning the scope of review revolve.

K. DAVIS, ADMINISTRATIVE LAW OF THE SEVENTIES 688-89 (1976).

[133] *See* 5 K. DAVIS, ADMINISTRATIVE LAW TREATISE § 29:11, at 375-76 (2d ed. 1984) ("During the past few years, the Court has started to use the language of 'deference' for an agency's view, but the slight change in verbiage does not affect what the Court does, except that the idea of deference permits a straddle between the rightness test and the reasonableness test.").

[134] 467 U.S. 837, 842-44 (1984) ("We have long recognized that considerable weight should be accorded to an executive department's construction of a statutory scheme it is entrusted to administer . . . ."). *See also* Saunders, *Agency Interpretations and Judicial Review: A Search for Limitations on the Controlling Effect Given Agency Statutory Constructions*, 30 ARIZ. L. REV. 769, 770 (1988) ("Developments in recent years have blurred the distinction between legislative and interpretative rules to the point where at least some, and perhaps all, interpretative rules are now accorded legislative effect . . . ."); Kmiec, *supra* note 131, at 271-80 (arguing that *Chevron* was a natural outgrowth of the decline of the nondelegation doctrine); *id.* at 281, 286 (noting the link between *Chevron* and the decline of Panama Ref. Co. v. Ryan, 293 U.S. 388 (1935)).

reasonable. For example, in interpreting the term "deceptive practices" in the Federal Trade Act, the Supreme Court described its relationship to the Federal Trade Commission as follows:

> This Court has frequently stated that the Commission's judgment is to be given great weight by reviewing courts. . . . Nevertheless, while informed judicial determination is dependent upon enlightenment gained from administrative experience, in the last analysis the words 'deceptive practices' set forth a legal standard and they must get their final meaning from judicial construction.[135]

The second consequence of the breakdown of a clear distinction between the spheres of agency and judicial power was inconsistency. Without recourse to spheres, courts vacillated unpredictably between deference and independent judgment.[136] In one case, the Supreme Court described the "great deference to the interpretation given the statute by the officers or agency charged with its administration,"[137] while in another case, it observed that the meaning of statutory terms "must ultimately be resolved, not on the basis of matters within the special competence of the [agency], but by judicial application of canons of statutory construction."[138]

B. Erratic Extension of the One-Way Rule

The two consequences associated with the collapse of the sharply delineated agency and judicial realms of competence were reflected in the use of the one-way rule. Just as deference to agencies was extended to determinations outside the scope of the statute, so also

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135 FTC v. Colgate-Palmolive Co., 380 U.S. 374, 385 (1965) (footnotes omitted). *See* Federal Maritime Comm'n v. Seatrain Lines, Inc., 411 U.S. 726, 745-46 (1973); Volkswagenwerk v. Federal Maritime Comm'n, 390 U.S. 261, 272, *amended*, 392 U.S. 901 (1968); *see also* Labor Bd. v. Brown, 380 U.S. 278, 291 (1965) ("Courts should be 'slow to overturn an administrative decision,' but they are not left 'to sheer acceptance' of the Board's conclusions.") (citations omitted); Diver, *supra* note 19, at 562-63.

136 Diver, *supra* note 19, at 563-64. *See* 5 K. DAVIS, *supra* note 132, at 375 ("[T]he Supreme Court has long maintained two lines of cases on the scope of review of applying law to undisputed or established facts. In one line, the Court substitutes judgment, and in the other line it uses a reasonableness or rational basis test."); B. SCHWARTZ, *supra* note 55, at 659 (noting inconsistent application of doctrine of *Gray v. Powell*); Starr, *Judicial Review in the Post-Chevron Era*, 3 YALE J. ON REG. 283, 292-94 (1986) (describing two lines of cases); *see also* Judge Friendly's discussion in Pittston Stevedoring Corp. v. Dellaventura, 544 F.2d 35, 49 (2d Cir. 1976) (With respect to deference to agency interpretations of statutes, "there are two lines of Supreme Court decisions on this subject which are analytically in conflict."), *aff'd sub nom.* Northeast Marine Terminal Operating Co. v. Caputo, 432 U.S. 249 (1977).

137 Udall v. Tallman, 380 U.S. 1, 16 (1965).

138 Barlow v. Collins, 397 U.S. 159, 166 (1970).

was the one-way rule extended to a wide variety of issues beyond related-party sales. Just as courts erratically alternated between deference and independent judgment, so also did they equivocate between adoption and rejection of the one-way rule.

This erratic extension surfaced in a variety of settings: recognition of choice of entity, corporate distributions and adjustments, other related-party transactions, and unrelated-party transactions. Courts expanded the one-way rule to situations in which economic reality was obscure, albeit not as obscure as related-party sales. Thus, courts were most drawn to the rule in interpreting statutory terms of art lacking real life analogues,[139] and in analyzing related-party transactions.

1. *Recognition of Choice of Entity*

Choice of business entity is inherently a formal inquiry. Corporations are by definition legal fictions. Thus, although several courts followed *Moline Properties, Inc. v. Commissioner*[140] and *National Carbide Corp. v. Commissioner*,[141] and rejected the one-way rule on issues of corporate existence and agency,[142] others relied upon the rule to decide whether a corporation existed for tax purposes.[143]

Two Tax Court decisions from the same term illustrate this equivocation. In deciding whether certain insurance income was earned by a corporation or its sole shareholder, the Tax Court in

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139 *See* Isenbergh, *Musings on Form and Substance in Taxation* (book review), 49 U. CHI. L. REV. 859, 879 (1982) ("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.") (emphasis in original).

140 319 U.S. 436 (1943).

141 336 U.S. 422 (1949).

142 *See* United States v. Brager Bldg. & Land Corp., 124 F.2d 349, 351 (4th Cir. 1941) ("[I]t is going too far to say that if a taxpayer forms a corporation for his convenience, he is thereafter estopped from disclosing the true nature of the arrangement, whenever it is of advantage to the government to recognize only the corporate form."). For a recent case in which the taxpayer successfully asserted the agency theory, see Commissioner v. Bollinger, 485 U.S. 340 (1988).

143 *See, e.g.*, Commissioner v. State-Adams Corp., 283 F.2d 395, 398-99 (2d Cir. 1960) ("[T]he Commissioner, [in order] to prevent unfair tax avoidance, has greater freedom and responsibility to disregard the corporate entity than a taxpayer, who normally cannot be heard to complain that a corporation which he has created, and which has served his purpose well, is a sham."), *cert. denied*, 365 U.S. 844 (1961); Love v. United States, 96 F. Supp. 919, 921 (Ct. Cl. 1951) ("[T]he taxpayer may not escape the tax consequences of a business arrangement which he [has] made upon the asserted ground that the arrangement was fictional.").

Shaw v. Commissioner[144] stated that the "preference for substance over form in tax matters extends to claims of petitioner and respondent alike."[145] Within four months, however, in determining whether corporations organized to hold title in order to avoid state law usury restrictions constituted agents of the shareholder, the same court in *Bolger v. Commissioner*[146] acknowledged that "the taxpayer may have less freedom than the Commissioner to ignore the transactional form that he has adopted."[147]

Partnership formation entails different formalities than incorporation. Nonetheless, it is also difficult to attribute independent significance to the mutual agency created by a partnership agreement among related persons. Thus, courts also applied the one-way rule when a taxpayer, who had ostensibly formed a family partnership, later challenged its existence in order to claim its losses on his individual return.[148]

2. *Corporate Distributions and Adjustments*

Despite the detailed statutory rules contained in Subchapter C, corporate distributions lack an easily ascertained economic reality. Such distributions generally have no significance apart from their tax consequences. As one authority put it, "[T]here is no independent economic substance to a distribution. Its economic effect *is* the tax result . . . ."[149]

Thus, cases interpreting Subchapter C were divided. Some courts, following *Helvering v. Alabama Asphaltic Limestone Co.*,[150] rejected the one-way rule. For instance, in *Ciaio v. Commissioner*,[151] the Tax Court considered whether a corporation made a "distribution" when it purchased the stock on behalf of a continuing shareholder who formally had that obligation. The corporation

144 59 T.C. 375 (1972).

145 *Id.* at 383-84.

146 59 T.C. 760 (1973).

147 *Id.* at 767 n.4.

148 *See* Demirjian v. Commissioner, 457 F.2d 1, 5 (3d Cir. 1972) (describing cases holding that persons who represent to the IRS that property is owned by a partnership are bound by such representations); Maletis v. United States, 200 F.2d 97, 98 (9th Cir. 1952); Sherman v. United States, 141 F. Supp. 369, 370 (E.D. Pa. 1956), *aff'd*, 240 F.2d 600 (3d Cir. 1957); *see also* Commissioner v. Culbertson, 337 U.S. 733, 753 (1949) (Frankfurter, J., concurring) (suggesting that government might hold a taxpayer to his decision to enter into a partnership agreement).

149 Kingson, *The Deep Structure of Taxation: Dividend Distributions*, 85 YALE L.J. 861, 873 (1976) (emphasis in original).

150 315 U.S. 179 (1942).

151 47 T.C. 447 (1967).

had originally been the buyer in the agreement, but in order to obtain financing, had substituted the shareholder's name. Finding no "distribution" occurred, the court noted that, despite the formal substitution, the obligation to purchase the stock belonged to the corporation and not the continuing shareholder.[152] In reaching its conclusion, the court observed that "[t]he taxpayer as well as the Government is entitled to the benefit of the rule that the substance rather than the form of the transaction controls."[153]

Other courts, unable to see the economic reality underlying a redemption,[154] adopted the one-way rule. For example, in *Television Industries, Inc. v. Commissioner*,[155] Judge Friendly held for the Second Circuit that a dividend arose when a person purchased stock from a third party and immediately sold part of it back to the corporation. In dismissing the argument that the substance of the transaction was identical to a joint purchase by the purchaser and the corporation, Judge Friendly relied upon *Higgins*.[156] Similarly, in *Woodworth v. Commissioner*,[157] the Sixth Circuit found a dividend occurred when several shareholders borrowed from a corporation, bought out another shareholder, and surrendered part of their stock to the corporation in exchange for release of their debt. The court reached this result notwithstanding that no dividend would have occurred had the selling shareholder merely redeemed his stock.[158]

3. *Related-Party Transactions Generally*

Many tax issues do not turn on formal inquiries such as whether a corporation exists or whether a transaction falls within a term of art contained in the Code. Some Code concepts mimic business practice.[159] In such situations, there is more likely to be an ascer-

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[152] *Id.* at 461-62.

[153] *Id.* at 457; *see also* J. M. Turner & Co. v. Commissioner, 247 F.2d 370, 377 (4th Cir. 1957) (allowing taxpayer to argue that the substance of a transaction was a tax-free exchange).

[154] *See* I.R.C. § 302(b)(1) (1991).

[155] 284 F.2d 322 (2d Cir. 1960).

[156] *Id.* at 325.

[157] 218 F.2d 719 (6th Cir. 1955).

[158] *Id.* at 724. For other cases foreclosing shareholders from arguing that a distribution is not essentially equivalent to a dividend, see Edmister v. Commissioner, 391 F.2d 584, 586 (6th Cir. 1968); Wiseman v. United States, 371 F.2d 816, 818 (1st Cir. 1967); United States v. Collins, 300 F.2d 821, 825, *modified*, 303 F.2d 142 (1st Cir. 1962).

[159] [T]he Code taxes a 'sale' without defining what a sale is; business and commercial experience supply that knowledge. . . . It follows that someone who has engaged in a transaction cannot . . . make it a 'sale' simply by writing that

tainable economic reality. Nonetheless, the possibility that related parties will manipulate forms generally used in commercial transactions still gives cause for concern.

Thus, the same divided attitude seen in Subchapter C cases extended more generally to transactions among related parties. Some courts continued to search for economic reality in these transactions. In *Peerless Steel Equipment Co. v. Commissioner*,[160] for example, the Tax Court considered whether payments from a pension trust to a related corporation[161] were made to cancel a lease. In refusing to bind the corporation to the form of its agreement with the pension plan, the court observed:

> Though there may be some attractive reasons for requiring a taxpayer to adhere to the form that he has created, the even-handed application of the law requires us to allow taxpayers the opportunity to show that their true intent was different from what was said . . . .[162]

Other courts, doubtful of underlying economic reality, applied the one-way rule to related-party transactions. For example, in *Commissioner v. National Alfalfa Dehydrating & Milling Co.*,[163] the Supreme Court considered whether an amortizable bond discount arose from exchanging stock for debt. Finding that such discount required speculation as to market behavior,[164] the Court relied on *Higgins* to dismiss the taxpayer's argument that the transaction was equivalent to the sale of debt for cash followed by the redemption of the preferred stock.[165] Likewise, in *Freeman v. Commissioner*,[166] the Eighth Circuit denied shareholders the use of the installment method[167] in reporting income from a third-party note distributed in complete liquidation, but conceded that a note issued directly by

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> word at the top of the agreement. . . . [W]here the Code follows life, life is determinative.

Isenbergh, *supra* note 139, at 864-65 (footnotes omitted) (distinguishing statutes that refer to the world from statutes that create relationships themselves).

160 26 T.C.M. (CCH) 880 (1967).

161 The principal executive officers of the corporation were also trustees of the trust. *Id.* at 880.

162 *Id.* at 883, *see also* J. M. Turner & Co. v. Commissioner, 247 F.2d 370, 377 (4th Cir. 1957) (taxpayer not bound to the "bare form" of a transfer as a sale, and instead may characterize the transfer as a contribution to capital pursuant to an incorporation).

163 417 U.S. 134 (1974).

164 *Id.* at 149-55.

165 *Id.* at 149.

166 303 F.2d 580 (8th Cir. 1962).

167 *See* I.R.C. § 453 (1991).

the liquidating corporation would have qualified for that method.[168]

4. *Unrelated-Party Transactions*

As stated above, courts feel most secure in determining the economic reality for transactions among unrelated parties. For twenty years after *Bartels v. Birmingham*,[169] courts refused to apply the one-way rule to unrelated-party transactions.[170] One common issue on which a taxpayer was permitted to disregard a chosen form was whether a transaction constituted a sale or a loan. For example, in *Estate of Wienert v. Commissioner*,[171] Judge Wisdom held that despite casting a transaction as a loan, the holder of a production right in a mineral interest was nonetheless treated as owner and taxable thereon. In so holding, Judge Wisdom emphasized that "[r]esort to substance is not a right reserved for the Commissioner's exclusive benefit . . . . The taxpayer too has a right to assert the priority of substance . . . ."[172]

Another noteworthy situation involved characterizing payments made pursuant to a divorce settlement. In *Landa v. Commissioner*,[173] Judge Bazelon, relying on *Helvering v. F. & R. Lazarus & Co.*,[174] held that the characterization of payments contained in a written divorce settlement did not bind the taxpayer.[175] The result in *Landa* was widely followed.[176]

Nonetheless, even in unrelated-party transactions, courts occasionally cited the one-way rule. In *Victorson v. Commissioner*,[177] the Second Circuit relied on *Television Industries* to reject the taxpayer's argument that an agreement styled as an option should be

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168 *Freeman*, 303 F.2d at 584-85; *see also* Matthews v. United States, 36 A.F.T.R.2d (P-H) 5-5974 (D.S.C. 1975) (capital gains treatment under corporate liquidation provision (section 331) denied when distributions were made to the taxpayer rather than to his wholly owned corporation).

169 332 U.S. 126 (1947).

170 *See, e.g.*, Read v. Commissioner, 13 T.C.M. (CCH) 123, 128 (1954) (payments treated as received from the sale of a capital asset, notwithstanding representations in the contract that amounts were received in exchange for services rendered).

171 294 F.2d 750 (5th Cir. 1961).

172 *Id.* at 755.

173 206 F.2d 431 (D.C. Cir. 1953).

174 308 U.S. 252 (1939).

175 *Landa*, 206 F.2d at 432.

176 *See, e.g.*, Bardwell v. Commissioner, 318 F.2d 786, 789 (10th Cir. 1963); Riddell v. Guggenheim, 281 F.2d 836, 840 (9th Cir. 1960); Thorsness v. United States, 260 F.2d 341, 345 (7th Cir. 1958).

177 326 F.2d 264 (2d Cir. 1964).

treated as an immediate sale.[178] Likewise, in determining the character of gain from selling a contract, that same court later used *Television Industries* to bind a taxpayer to his decision to enter into a new contract rather than renegotiate a prior one.[179]

C. Variable Weight Accorded the One-Way Rule

The collapse of sharply demarcated spheres also affected the weight given the one-way rule. Just as courts regarded administrative determinations as "factors" in determining statutory meaning, they also viewed an argument's pedigree as a mere "factor" in resolving a tax case. The phase two cases invariably bolstered their recitation of the one-way rule with arguments that the result comported with the substance of the transaction,[180] or that the form of the transaction controlled for tax purposes.[181] For example, Judge Friendly did not conclude his analysis in *Television Industries* with a recitation of the one-way rule but instead went on to find the transaction essentially equivalent to a dividend within the statutory language.[182]

Warsaw Photographic Associates, Inc. v. Commissioner[183] further illustrates this equivocation. In *Warsaw Photographic*, the Tax Court apparently held the taxpayer, but not the Commissioner, to the requirement that the transferee corporation actually transfer and distribute its stock in order to qualify as a "D" reorganization.[184] Close reading of the decision reveals, however, that the

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[178] *Id.* at 266.

[179] Brook v. Commissioner, 360 F.2d 1011, 1014 (2d Cir. 1966).

[180] *See* Groetzinger v. Commissioner, 87 T.C. 533, 541-42 (1986) (applying the one-way rule but also finding that form coincided with substance).

[181] *See* Woodworth v. Commissioner, 218 F.2d 719, 724 (6th Cir. 1955) ("Indeed the statute directs that the 'manner' of the transaction be a controlling factor.").

[182] Television Indus., Inc. v. Commissioner, 284 F.2d 322, 325 (2d Cir. 1960).

[183] 84 T.C. 21 (1985).

[184] *Id.* at 43.

> [I]n each of these cases in which a court has held that the requirement of an actual stock transfer and distribution may be ignored, it was respondent who urged on the court that the realities of the situation belied the form chosen by the taxpayer. In those situations where the courts have departed from the literal language of the statute, it was to counter a perceived abuse by the taxpayer, these courts having concluded that the taxpayer should not be permitted to shape the form of the transaction so as to secure an unwarranted benefit. . . . We have not found, and petitioner has not cited us to, any case in this area in which the court has acceded to a taxpayer's urging that the taxpayer be permitted to obtain a D reorganization tax benefit even though the form of the transaction which the taxpayer shaped did not meet the literal requirements of the statute.

court also distinguished the cases in which no actual transfer and distribution occurred as involving identical ownership.[185] The court also rejected the argument that there were equivalent means by which the taxpayer might have achieved the same tax result.[186] The court did not, however, rest there, and went on to say that "[w]hen we examine the substance of what was done, we conclude that it points toward 'sale' at least as much as toward 'reorganization.' "[187]

The tendency to supplement the one-way rule is evident in virtually all phase two cases. The partnership cases, for example, also equivocated between the one-way rule and other grounds.[188] For example, in *Sherman v. United States*,[189] the court initially stated that the taxpayer could not disavow the business form,[190] but ultimately found that a partnership existed because of the intent of the parties.[191]

D. *Choice and Certainty Replace Election and Tax Avoidance as Rationales for the One-Way Rule*

With the collapse of sharply demarcated spheres, the rationale for the one-way rule became broader and more inclusive. At first glance, the phase two cases appeared to adopt the phase one theory, citing *Higgins* and alluding to the taxpayer's election. They contain formulations such as " 'once a taxpayer elects a particular mode of business procedure, he cannot avoid the statutory ramifications of his action by indicating results which might have obtained under

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Id. at 39 (citation omitted); *see* I.R.C. § 368(a)(1)(D) (1991).

185 "All of these authorities on which petitioner relies are distinguishable from the instant case in that the transferors and transferees in those instances had identical ownership, while in the instant case, the ownership interests . . . differed widely." *Warsaw Photographic*, 84 T.C. at 39 (footnote omitted). Presumably, the presence of identical ownership lessened the need to comply with statutory niceties because it indicated that no substantive change in ownership had occurred.

186 *Id.* at 40 n.23 (" 'Petitioners are liable for the tax consequences of the transaction that they actually executed; they may not reap the benefits of some other transaction that they might have effected instead.' ") (quoting Brown v. Commissioner, 706 F.2d 755, 756 (6th Cir. 1983) (citations omitted)).

187 *Id.*

188 *See* Demirjian v. Commissioner, 457 F.2d 1, 4-5 (3d Cir. 1972) (finding of fact that partnership existed); Phillips v. United States, 193 F.2d 132, 134 (5th Cir. 1951) (finding sharing of profits and losses).

189 141 F. Supp. 369, 371 (E.D. Pa. 1956), *aff'd*, 240 F.2d 600 (3d Cir. 1957).

190 *Sherman*, 141 F. Supp. at 370.

191 *Id.* at 371.

alternate procedures,' "[192] and the taxpayer "elected the form and arrangement in which he would do business."[193]

Despite this reliance, the phase two cases in fact generalize the phase one theory. They apply the one-way rule in a variety of situations in which it is difficult to find an "election" or "tax avoidance," as *Higgins* used those terms. As mentioned above, a binding election can be made only if two permissible tax characterizations exist; no binding election can be made if only one proper tax treatment exists.[194] In *Higgins*, the alternative tax consequences flowed from the choice of either respecting or disregarding the corporate entity.[195] In the phase two cases, the alternative tax consequences do not flow from this choice. An election exists in the phase two cases only if tax law, and corporate tax law in particular, is itself elective, because its formality allows taxpayers to choose their tax consequences.

Jurists occasionally articulate this broad view of election. Professor Chirelstein, for instance, credits Judge Learned Hand with viewing the Code as "in part a clumsy system of implied elections, of which some, such as the choice to do business in corporate form, are freely exercisable by the taxpayer and binding on the Commissioner, while others, notably those involving self-dealing transactions, are within the Commissioner's discretion to approve or reject."[196] Under this view, ambiguous transactions are generally characterized in the Commissioner's favor unless the taxpayer shows that economic substance supports the form.[197] This broad view of election, however, is not generally accepted.[198]

Accordingly, the phase two cases slipped from the rhetoric of election into the rhetoric of choice:

> If a taxpayer having a choice of methods accomplishing an economic or business result pursues a particular means to accomplish his ends, he must abide the tax consequences resulting from his choice of methods, even though had he made another choice

[192] Wiseman v. United States, 371 F.2d 816, 818 (1st Cir. 1967) (quoting United States v. Collins, 300 F.2d 821, 825, *modified*, 303 F.2d 142 (1st Cir. 1962)).

[193] Maletis v. United States, 200 F.2d 97, 98 (9th Cir. 1952); *see also Sherman*, 141 F. Supp. at 370 ("[P]laintiffs elected to begin and continue business as a partnership, and they will not now be heard to disavow that partnership.").

[194] *See supra* note 89 and accompanying text.

[195] Higgins v. Smith, 308 U.S. 473, 475-76 (1940).

[196] Chirelstein, *supra* note 106, at 471.

[197] *See* Gilbert v. Commissioner, 248 F.2d 399, 410-12 (2d Cir. 1957) (Hand, J., dissenting); *see also* Chirelstein, *supra* note 106, at 464.

[198] *See* 1 B. BITTKER & L. LOKKEN, *supra* note 3, ¶ 4.3.3.

> the tax consequences would have been less severe or even nonexistent.[199]

"Choice" does not imply a binding selection between equally acceptable alternatives. Rather, that term permits courts to give weight to a characterization whenever doubt exists as to the proper tax treatment.

It is also difficult to stretch the notion of tax avoidance to phase two fact situations. In phase two cases, the taxpayer's scheme does not threaten to supersede the taxing statute; indeed, the issue at hand is often within congressional contemplation.[200] Thus, these cases do not mention tax avoidance, but instead emphasize the more general need for certainty. For example, in *Television Industries*, Judge Friendly noted:

> The Commissioner is justified in determining the tax effect of transactions on the basis in which taxpayers have molded them, although he may not always be required to do so. It would be quite intolerable to pyramid the existing complexities of tax law by a rule that the tax shall be that resulting from the form of transaction taxpayers have chosen or from any other form they might have chosen, whichever is less.[201]

Likewise, in *National Alfalfa*, the Supreme Court observed:

> [W]hile a taxpayer is free to organize his affairs as he chooses, nevertheless, once having done so, he must accept the tax consequences of his choice, whether contemplated or not, and may not enjoy the benefit of some other route he might have chosen to follow but did not. 'To make the taxability of the transaction depend upon the determination whether there existed an alternative form which the statute did not tax would create burden and uncertainty.'[202]

[199] Freeman v. Commissioner, 303 F.2d 580, 584-85 (8th Cir. 1962). For similar formulations, see Edmister v. Commissioner, 391 F.2d 584, 586 (6th Cir. 1968) ("[T]he Commissioner and the Courts are justified in treating transactions for tax purposes according to the plan adopted by the taxpayer rather than on the basis of some other plan that might have been adopted."); Woodworth v. Commissioner, 218 F.2d 719, 724 (6th Cir. 1955) (quoting Woodruff v. Commissioner, 131 F.2d 429, 430 (5th Cir. 1942)) (" 'If a taxpayer has two legal methods by which he may attain a desired result, the method pursued is determinative for tax purposes without regard to the fact that different tax results would have attached if the alternative procedure had been followed.' ").

[200] *See, e.g.*, Commissioner v. National Alfalfa Dehydrating & Milling Co., 417 U.S. 134, 149 (1974); Television Indus., Inc. v. Commissioner, 284 F.2d 322, 325 (2d Cir. 1960); *see also supra* notes 94 & 107 and accompanying text.

[201] *Television Indus., Inc.*, 284 F.2d at 325 (citations omitted).

[202] *National Alfalfa*, 417 U.S. at 149 (citations omitted) (quoting Founders Gen. Corp. v. Hoey, 300 U.S. 268, 275 (1937)); *see also* Victorson v. Commissioner, 326 F.2d 264, 266 (2d Cir. 1964) (acceding to taxpayer's arguments regarding form "would introduce unnecessary uncertainty into future cases").

To summarize, despite their reliance on *Higgins*, the phase two cases used the one-way rule differently. Seldom decisive, sometimes ignored, the rule generally served to conserve the judicial resources that a lengthy inquiry into economic reality would expend. Unwilling to abandon wholly the inquiry into economic reality in the absence of statutory authorization, courts hedged their holdings by leaving open the door to an IRS challenge on similar facts.

IV

Phase Three: Heightened Weight Accorded the One-Way Rule Based on Theories of Bargain and Whipsaw

A. *From Economic Reality to Transactional Consistency*

During phase three, the one-way rule was chiefly influenced by two intellectual movements outside administrative law. Together, these movements made courts more willing to substitute transactional consistency for economic reality.

1. *Growing Doubt About Economic Reality*

The first movement making courts more willing to appeal to transactional consistency was an increasing doubt in the existence of an objective economic reality. This movement paralleled developments in statutory interpretation generally. As mentioned above, courts ameliorated the tension between formal and substantive interpretation during the 1940s and 1950s by searching for "statutory purpose," a term that avoided rigidity while curbing judicial discretion.[203] After 1960, however, jurists increasingly viewed the legislative process as reaching compromises among competing interest groups. In this context, the courts found it difficult to believe that a statute embodied a transcendent purpose.[204] Without statutory purpose, jurists resorted to other means of resolving the tension between formal and substantive decisionmaking.

In tax law, "economic reality" plays much the same role that "statutory purpose" does in statutory law generally. It is therefore not surprising that from 1960 to 1990 jurists grew increasingly skeptical about the existence of an independent economic reality apart from tax consequences. Viewing tax law as the product of a

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[203] *See* Blatt, *supra* note 29, at 828-34.
[204] *See id*. at 837-43.

compromise among competing interest groups,[205] they found it harder to believe in an underlying economic reality. One symptom of this shift was the growing realization that many tax rules are better understood as implementing expenditure programs[206] than as measuring income.[207]

Another symptom was the growing recognition that tax considerations often shape commercial practice. As a practical matter, the most important consequence of a state law characterization may be its federal income tax effect. For example, the whole purpose of a sale-leaseback transaction may be to allocate the benefit of the depreciation deduction. In such situations, commercial practice ceases to provide an objective reference point for economic reality.

2. *Rise of the Transactional Approach to Taxation*

The second movement making courts more willing to look for transactional consistency was a movement toward what might be termed a "transactional" approach to taxation. This approach replaced taxation of individuals with taxation of transactions: the touchstone for taxation shifted from each taxpayer's income to the agreement among the taxpayers.

Focusing on the transaction, courts broadened their inquiry from the bipolar dispute between the IRS and a single taxpayer over economic reality to the relationship among several parties, of whom the IRS was but one. The movement toward the transactional approach may have been attributable to growing doubt regarding economic reality. Agnostic about the economic reality of each party's income, courts substituted consistency as a minimum threshold. Whatever the meaning of economic reality, it did not permit inconsistent treatment.

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205 *See, e.g.*, L. EISENSTEIN, THE IDEOLOGIES OF TAXATION 3-4 (1961); *see also id.* at 201 ("The public interest is not some manifest essence that transcends the realm of private interests. It is a changing product that is periodically distilled from the pressures of competing interests in response to the prevailing preferences of the moment."); Douglas, *Mr. Citizen vs. the Treasury* (Book Review), 56 NW. U.L. REV. 689, 689 (1961) ("Our tax system was not designed by noblemen only to be subverted by base people. It represents a series of victories by special interest groups, each motivated by selfish ends.").

206 *See* S. SURREY, PATHWAYS TO TAX REFORM (1973); Bittker, *Accounting for Federal "Tax Subsidies" in the National Budget*, 22 NAT'L TAX J. 244 (1969). The Treasury Department adopted a tax expenditure budget in 1976. *See* U.S. OFFICE OF MANAGEMENT AND BUDGET, SPECIAL ANALYSIS: BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 1976, at 101-17 (1976).

207 *See* Coven, *The Decline and Fall of Taxable Income*, 79 MICH. L. REV. 1525 (1981).

The transactional approach was variously manifested. One manifestation was the judicial understanding of Subchapter K of the Code, which governs partnerships. Appealing to the "flexibility"[208] implicit in Subchapter K, courts abandoned the inquiry into economic reality and deferred to the partnership agreement. According to the Tax Court:

> Tax law in respect of partners may often involve a delicate mechanism, for a ruling in favor of one partner may automatically produce adverse consequences to the others. Accordingly, one of the underlying philosophic objectives of the 1954 Code was to permit the partners themselves to determine their tax burdens *inter sese* to a certain extent . . . . The theory was that the partners would take their prospective tax liabilities into account in bargaining with one another.[209]

This reasoning extended beyond Subchapter K. For example, in distinguishing debt from equity in *Ragland Investment Co. v. Commissioner*,[210] the Tax Court considered it relevant that "the parties entered into protracted arm's-length bargaining concerning the form the transaction should take with full awareness that a tax advantage to one would result in a concomitant tax disadvantage to the other."[211] The significance of this step is evident in the dissenting opinion, which sharply criticized the theory that "the parties to a business transaction can determine between themselves which party the Government shall tax."[212]

Another manifestation of the transactional approach was the increasing attention courts paid to the possibility that unrelated persons might whipsaw the government. The very perception of a whipsaw problem in unrelated-party transactions assumes that the transaction, rather than the particular party before the court, is the appropriate frame of reference. Before 1965, inconsistent positions

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208 *See* H.R. REP. NO. 1337, 83d Cong., 2d Sess. 65 (1954) (describing principal objectives as "simplicity, flexibility, and equity as between the partners"); S. REP. NO. 1622, 83d Cong., 2d Sess. 89 (1954) (same).

209 Foxman v. Commissioner, 41 T.C. 535, 551 (1964) (footnote omitted), *aff'd*, 352 F.2d 466 (3d Cir. 1965). *See also* Smith v. Commissioner, 37 T.C. 1033, 1038 (describing flexibility as allowing the partners to "determine the tax consequences of a liquidation payment by the choice of words in the partnership agreement") (footnote omitted), *aff'd*, 313 F.2d 16 (10th Cir. 1962).

210 52 T.C. 867 (1969), *aff'd per curiam*, 435 F.2d 118 (6th Cir. 1970).

211 *Ragland*, 52 T.C. at 878.

212 *Id.* at 879 (Tietjens, J., dissenting) (noting that form opens questions under the taxing statute rather than closes them); *see also* Plumb, *The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal*, 26 TAX L. REV. 369, 450-57 (1971).

were troubling only when held by related taxpayers. The leading study of inconsistent reporting positions focused only on related taxpayers,[213] and the provisions of the 1954 Code, intended to mitigate the effect of such inconsistencies, addressed only inconsistencies among related taxpayers.[214] After 1965, however, whipsaw resulting from transactions among unrelated taxpayers received considerable attention. Courts grew increasingly concerned with whipsaw,[215] and several law review articles specifically defined "whipsaw" to include transactions among unrelated persons.[216]

A suggestive analogue for the emergence of the transactional approach to taxation is the growing emphasis on the transaction in civil procedure during the same period.[217] In the 1940s, for pleading purposes, a claim generally was confined to a narrowly defined "cause of action," a particular legal theory applied to a set of facts. By the 1980s, however, a claim had been expanded to include all legal consequences arising from a given transaction or occurrence.[218] As a consequence, the class of persons allowed to intervene in litigation grew from those potentially bound by the

[213] *See* Plumb, *The Problem of Related Taxpayers: A Procedural Study*, 66 HARV. L. REV. 225 (1952). Although Plumb defined the term "related taxpayer" broadly to include any persons who may be taxable on the same income, the only apparent purpose of this broad definition was to include ex-spouses, not persons wholly lacking in relationship. *Id.* at 226 nn.4-5.

[214] *See* I.R.C. §§ 1312, 1313(c)(1) (1958).

[215] A Lexis search performed July 8, 1991 revealed that the word "whipsaw" appeared 63 times in federal tax cases, but only three times before 1970.

[216] *See* Lake, *The Whipsaw Problem in Federal Tax Controversies*, 34 INST. ON FED. TAX'N 867, 867 (1976) ("[T]he whipsaw problem can be defined as the assertion of inconsistent tax claims by or against two parties to the same transaction where only one claim should logically succeed under the tax laws."); Miller, *Remarks*, 25 TAX LAW. 193, 193 (1972) ("A whipsaw situation occurs in the tax field when two different taxpayers take positions with respect to a particular transaction which are so inconsistent with each other that only one should logically succeed . . . ."); *see also* Special Committee on Whipsaw, *supra* note 7.

[217] *See* Chayes, *The Role of the Judge in Public Law Litigation*, 89 HARV. L. REV. 1281, 1282, 1290 (1976); *see also* Stewart, *The Reformation of American Administrative Law*, 88 HARV. L. REV. 1669 (1975) (describing the emergence of the interest representation model of administrative law, under which litigation was no longer treated as bipolar).

[218] *Compare* RESTATEMENT OF JUDGMENTS § 61 (1942) (cause of action test) *with* RESTATEMENT (SECOND) OF JUDGMENTS § 24 (1982) (transaction test); *compare also* Cleary, *Res Judicata Reexamined*, 57 YALE L.J. 339, 343 (1948) (proposing cause of action approach) *with* C. WRIGHT, A. MILLER & E. COOPER, FEDERAL PRACTICE AND PROCEDURE § 4407 (1981) (defending transactional approach). *See id.* §§ 4463-64 (discussing traditional requirement of mutuality and its abandonment); RESTATEMENT (SECOND) OF JUDGMENTS § 24 comment a, h (1982) (describing shift from cause of action to transactional approach).

judgment to all interested in the transaction.[219] Although no one consciously linked developments in tax law with those in civil procedure, this simultaneous emphasis on transaction suggests a common mindset.

3. *From* Lazarus *to* Frank Lyon

The movement from economic reality to transactional consistency is evident in two Supreme Court decisions involving sale-leaseback transactions, decided nearly forty years apart. In 1939, the Court in *Helvering v. F. & R. Lazarus & Co.*[220] determined that the conveyance of title to real property to a bank, coupled with a ninety-nine year lease with an option to renew and purchase, constituted a mere security agreement for a mortgage and that the nominal lessee could therefore depreciate the property.[221] Without hesitation, the Court determined economic reality by looking to case law treating a deed executed as security for a loan as a mortgage for purposes of equity jurisdiction.[222]

Thirty-nine years later, in *Frank Lyon Co. v. United States*,[223] the Court experienced far greater difficulty in determining the economic reality underlying another sale-leaseback transaction and held that the lessor could depreciate the property. Although inquiring into the "objective economic realities" of the transaction, the Court conceded that there was "no simple device available to peel away the form of this transaction and to reveal its substance."[224] Acknowledging "the reality that the tax laws affect the shape of nearly every business transaction,"[225] the Court did not make state law control-

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219 *Compare* FED. R. CIV. P. 24 (1938) (granting right to intervene to a person who would be bound by the judgment or adversely affected by the disposition of property within the control of court) *with* FED. R. CIV. P. 24(a) (1966) (granting right to intervene to any person claiming "an interest relating to the property or transaction which is the subject of the action" if the person "is so situated that the disposition of the action may as a practical matter impair or impede his ability to protect that interest"). *See generally* Kaplan, *Continuing Work of the Civil Committee: 1966 Amendments of the Federal Rules of Civil Procedure (I)*, 81 HARV. L. REV. 356, 400-07 (1967) (describing changes in the 1966 amendments); C. WRIGHT, A. MILLER & E. COOPER, *supra* note 218, § 1903 (same). *See also* Shapiro, *Some Thoughts On Intervention Before Courts, Agencies, and Arbitrators*, 81 HARV. L. REV. 721, 721-22 (1968) (describing broadened rights of intervention).

220 308 U.S. 252 (1939).

221 *Id.* at 255.

222 *Id. See supra* note 115 and accompanying text.

223 435 U.S. 561 (1978).

224 *Id.* at 576.

225 *Id.* at 580.

ling on the issue of ownership, but instead looked to whether the lessor retained "significant and genuine attributes of traditional lessor status."[226]

Uneasy about economic reality, the Court considered the overall tax effect of the transaction on all parties. It was:

> not inappropriate to note that the Government is likely to lose little revenue, if any, as a result of the shape given the transaction by the parties. No deduction was created that is not either matched by an item of income or that would not have been available to one of the parties if the transaction had been arranged differently.[227]

The Court also emphasized "the absence of any differential in tax rates and of special tax circumstances for one of the parties,"[228] which would reduce the total tax collected as a result of the transaction. Accordingly, the Court gave the taxpayer the benefit of the form. Although *Frank Lyon* did not involve a taxpayer challenge to form, it demonstrated the extent to which courts backed away from economic reality and toward a transactional approach.

B. Reliance on Formal Interpretation and the One-Way Rule in Transactions Between Unrelated Parties

Frank Lyon merely expressed a preference for respecting form and for considering the overall taxation of all parties to the transaction. From 1960 to 1990, jurists went beyond merely expressing a preference and instead adopted formal rules designed to assure consistent treatment of the transaction.

One of these formal rules simply made form determinative.[229] This rule ignored the effect upon the fisc and the possibility that form might not coincide with economic reality. The other formal rule was the one-way rule. This rule recognized the effect of formal rules on the fisc and the potential need to resort to economic reality in the future. Rather than engaging in an independent inquiry to determine the effect of the transfer upon the fisc, courts relied on

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226 *Id.* at 584.

227 *Id.* at 580.

228 *Id.* at 583. For discussion of whether bracket differential in fact existed in *Frank Lyon*, see Wolfman, *The Supreme Court in the Lyon's Den: A Failure of Judicial Process*, 66 CORNELL L. REV. 1075, 1094-98 (1981).

229 *See, e.g.*, Treas. Reg. § 1.1245-1(a)(5) (1990) ("In general, if a buyer and seller have adverse interests as to the allocation, . . . any arm's length agreement between the buyer and the seller will establish the allocation."); Treas. Reg. § 1.736-1(b)(1) (1990) ("Generally, the valuation placed by the partners upon a partner's interest in partnership property in an arm's length agreement will be regarded as correct.").

the Commissioner, as protector of the revenues and principal beneficiary of substantive interpretation, to raise the issue.

Thus, in the 1960s, 1970s, and 1980s, courts increasingly applied the one-way rule in unrelated-party situations. Thus, the rules of *Lazarus* and *Landa*, which allowed taxpayers engaging in transactions with unrelated persons an unrestricted right to challenge form, and which had enjoyed broad support since the 1940s and 1950s, were suddenly challenged.[230]

1. Allocating Purchase Price to a Covenant Not to Compete

Formal interpretation first emerged with respect to the allocation of purchase price to a covenant not to compete entered pursuant to a sale of a business.[231] Such a covenant may lack commercial purpose,[232] and determining the economic reality underlying such a covenant poses troubling factual issues. First, it is often uncertain whether a covenant is an asset "distinct and severable" from the underlying business.[233] Even if it is, valuing such a covenant can be very difficult because noncompetitive covenants are not freely traded and are seldom valued for other purposes.[234] Given these

230 *Compare* Helvering v. F. & R. Lazarus & Co., 308 U.S. 252 (1939) (one-way rule not applied to sale-leaseback transaction) *with* Coleman v. Commissioner, 87 T.C. 178 (1986) (one-way rule applied to sale-leaseback transaction), *aff'd*, 833 F.2d 303 (3d Cir. 1987); *compare also* Landa v. Commissioner, 206 F.2d 431 (D.C. Cir. 1953) (taxpayer allowed to appeal to substance of divorce settlement) *with* Schatten v. United States, 746 F.2d 319 (6th Cir. 1984) (taxpayer bound to form of divorce settlement agreement).

231 The tax law requires that sales price be allocated to assets sold together in accordance with their fair market values. *See* Williams v. McGowan, 152 F.2d 570 (2d Cir. 1945); Treas. Reg. § 1.167(a)-5 (1991) (Where the taxpayer acquires nondepreciable and depreciable property for a lump sum, "the basis for depreciation cannot exceed an amount which bears the same proportion to the lump sum as the value of the depreciable property at the time of acquisition bears to the value of the entire property at that time."); Treas. Reg. §§ 1.1245-1(a)(5), 1.1250-1(a)(i)(*b*) (1990); Rev. Rul. 55-79, 1955-1 C.B. 370 (a sale of a business is a sale of the assets comprising the business, and the sale price must be allocated to the assets in accordance with their fair market values). *See generally* Bogdanski, *Contractual Allocations of Price in Sales of Businesses*, 15 J. CORP. TAX'N 99 (1988).

232 *See* Rosen, *supra* note 3, at 739 (describing a noncompetition provision as "essentially meaningless").

233 *See* 5 J. MERTENS, *supra* note 61, § 23A.93, at 222 ("Where . . . a covenant not to compete is nonseverable from a transfer of goodwill in the sale of a going concern, the covenant is not subject to depreciation even though the parties place a separate value on it.") (footnote omitted); Beghe, *Income Tax Treatment of Covenants Not to Compete, Consulting Agreements and Transfers of Goodwill*, 30 TAX LAW. 587, 589 (1977) (discussing severability test); Comment, *Tax Treatment of a Covenant Not to Compete*, 8 STAN. L. REV. 485, 488 (1956).

234 *See* Amerada Hess Corp. v. Commissioner, 517 F.2d 75, 85 (3d Cir.) ("*[O]nly* the parties to [a covenant not to compete] could value it; there exists no outside valuation

difficulties, the contract price was a reasonable surrogate for economic reality.

Moreover, a covenant not to compete posed an attractive case for applying the transactional approach. The tax consequences of the covenant to the buyer and seller are roughly offsetting: allocations to the covenant increase the buyer's basis in an amortizable asset, while allocations away from the covenant maximize the benefit of the seller's capital gains preference. The size of the transaction and the sophistication of the parties made substantial negotiation over the contract allocations likely.

(a) Additional Weight Given Form: The Strong Proof Rule

In two lines of cases emerging after 1950, courts replaced economic reality with formal interpretation. The first line adopted the "strong proof" rule, which deemed the price specified in the contract to be correct, absent "strong proof" to the contrary.[235] Initially, courts defended this rule as a means of determining the economic reality of the transaction. In the case credited with originating the strong proof rule, *Hamlin's Trust v. Commissioner*,[236] the Tenth Circuit conceded that the sellers did not consider the tax consequences of their contract but nonetheless held them to the allocation contained in it: "Having thus agreed, the taxpayers are not at liberty to say that such was not the substance and reality of the transaction."[237] Unfortunately, the court did not explain *why* the agreement was the substance and reality of the transaction.

The explanation came in *Ullman v. Commissioner*,[238] in which the Second Circuit appealed to the adverse tax interests of buyer and seller: the seller typically wishes to allocate a low value to the covenant so as to maximize his capital gain, while the buyer wants to allocate a high value to the covenant so as to increase his amorti-

index."), *cert. denied*, 423 U.S. 1037 (1975); Schulz v. Commissioner, 294 F.2d 52, 55 (9th Cir. 1961) (referring to the "impossible task of assigning fair values to good will and to covenants").

235 *See* Ullman v. Commissioner, 264 F.2d 305, 308 (2d Cir. 1959) ("[W]hen the parties to a transaction . . . have specifically set out the covenants in the contract and have there given them an assigned value, strong proof must be adduced by them in order to overcome that declaration.").

236 209 F.2d 761 (10th Cir. 1954).

237 *Id.* at 765; *see also* Wilson Athletic Goods Mfg. Co. v. Commissioner, 222 F.2d 355, 357 (7th Cir. 1955) (citing *Hamlin's Trust* for the proposition that tax consequences are determined by looking to realities).

238 264 F.2d 305 (2d Cir. 1959).

zation deduction. Thus, the court concluded, "The tax avoidance desires of the buyer and seller . . . are ordinarily antithetical, forcing them, in most cases, to agree upon a treatment which reflects the parties' true intent with reference to the covenants, and the true value of them in money."[239]

While not completely abandoning economic reality, the strong proof rule constituted a significant step away from it. The contract allocation may not reflect the economic reality behind the transaction, but rather the parties' relative knowledge or bargaining power. As in *Hamlin's Trust*, a party may be unaware of the covenant's tax consequences and fail to bargain with respect to it. Alternatively, the contract allocation may be set to minimize the overall tax liability of both parties.[240] The emphasis in *Ullman* on the offsetting effects of the capital gain preference and the amortization deduction, and its neglect of potential state law consequences,[241] suggest a shift from economic reality toward a transactional approach. The attenuated relationship of the strong proof rule to economic reality became more evident in later decisions, which only defend the rule as not respecting "obviously substanceless allocations."[242]

While moving toward a formal rule, the strong proof cases also gravitate toward the one-way rule. Some cases suggest that the Commissioner may be bound by the price contained in the contract.[243] Other cases, however, recognize the Commissioner's right

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239 *Id.* at 308. *See* Schulz v. Commissioner, 294 F.2d 52, 55 (9th Cir. 1961) ("Generally speaking, the countervailing tax considerations upon each taxpayer should tend to limit schemes or forms which have no basis in economic fact."). For commentary on *Ullman*, see Note, *Tax Treatment of Covenants Not to Compete: A Problem of Purchase Price Allocation*, 67 YALE L.J. 1261 (1958).

240 *See* 1 B. BITTKER & L. LOKKEN, *supra* note 3, ¶ 4.4.4.

241 The amount allocated to the covenant might, for instance, affect the recovery allowed for the breach of a covenant not to compete.

242 *See* Lazisky v. Commissioner, 72 T.C. 495, 501-02 (1979) ("Our test is designed to (1) produce predictability (and therefore reduce litigation) by generally enforcing agreements as made, and (2) assure at the same time that the Court is not hamstrung into enforcing obviously substanceless allocations.").

243 *See, e.g.*, Patterson v. Commissioner, 810 F.2d 562, 571 (6th Cir. 1987) (allocation to covenant not to compete given effect "absent a clear indication that such allocation is totally contrary to economic reality"); Theophelis v. United States, 751 F.2d 165, 167 (6th Cir. 1984) ("Generally, the amount allocated by the parties' agreement [to a seller's covenant not to compete] is controlling, because they have competing and conflicting tax interests."); *Schulz*, 294 F.2d at 55 ("The Commissioner should be slow in going beyond the values which the taxpayers state . . . ."); Schmitz v. Commissioner, 51 T.C. 306, 317 (1968) (refusing to distinguish challenges by the Commissioner from those by the taxpayer), *aff'd*, 457 F.2d 1022 (9th Cir. 1972).

to look beyond form.[244]

(b) *Form Binding Unless Unenforceable:* Commissioner v. Danielson

The second line of cases sprung from the Third Circuit opinion in *Commissioner v. Danielson*,[245] which went beyond the evidentiary "strong proof" rule and bound the taxpayer to the price stated in the sales contract, absent proof that would be admissible in a state court to alter the construction of the contract or to show its unenforceability.[246] By limiting the circumstances in which the taxpayer could challenge the form of the transaction, *Danielson* expressly adopted a formal rule that made no pretense of determining economic reality. Indeed, the court acknowledged that the covenant lacked the value stated in the contract and that the amount allo-

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244 *See* Dixie Fin. Co. v. United States, 474 F.2d 501, 504-05 (5th Cir. 1973) ("The parties cannot contractually preclude the Commissioner from attacking an allocation that has no basis in economic reality . . . [but] the taxpayer must generally accept the tax consequences which follow from the form he has chosen."); Copperhead Coal Co. v. Commissioner, 272 F.2d 45, 48 (6th Cir. 1959) (citing *Hamlin's Trust* for the proposition that "[t]he Tax Court is not bound by the allocation of values made in the purchase contract, and is free to increase or decrease the amounts so allocated in accordance with the facts"); Buffalo Tool & Die Mfg. Co. v. Commissioner, 74 T.C. 441, 446 (1980) (refusing to apply the "strong proof" rule to challenges by the Commissioner); Zeropack Co. v. Commissioner, 47 T.C.M. (CCH) 40,566 (Oct. 27, 1983), *aff'd by order*, (4th Cir. 1985) (same).

245 378 F.2d 771 (3d Cir.), *cert. denied*, 389 U.S. 858 (1967). For commentary on *Danielson*, see Comment, *Federal Income Taxation — Covenant Not to Compete — Right of Taxpayer to Contradict Terms of Sales Contract*, 53 IOWA L. REV. 963 (1968); Note, *Income Tax*, 46 TEX. L. REV. 108 (1967); Note, *Judicial Treatment of Covenants Not to Compete: The Third Circuit Takes a Giant Step*, 24 TAX L. REV. 513 (1969); Note, *The* Danielson *Rule: An Anodyne for the Pain of Reasoning*, 89 COLUM. L. REV. 1320 (1989).

246 *Danielson*, 378 F.2d at 775 (A party to a contract allocating a portion of the purchase price to a convenant not to compete may "challenge the tax consequences of his agreement as construed by the Commissioner only by adducing proof which in an action between the parties to the agreement would be admissible to alter that construction or to show its unenforceability because of mistake, undue influence, fraud, duress, etc.").

Curiously, courts embraced the parol evidence rule in taxation while backing away from it in contract law. *See* Murray, *The Parol Evidence Process and Standardized Agreements Under the Restatement (Second) of Contracts*, 123 U. PA. L. REV. 1342, 1342-53 (1975) (describing recent erosion of the parol evidence rule); Sweet, *Contract Making and Parol Evidence: Diagnosis and Treatment of a Sick Rule*, 53 CORNELL L. REV. 1036 (1968); Wallach, *The Declining 'Sanctity' of Written Contracts — Impact of the Uniform Commercial Code on the Parol Evidence Rule*, 44 MO. L. REV. 651 (1979). The decline of the rule in contract law was part of a larger movement away from formalism in contract law. *See generally* G. GILMORE, THE DEATH OF CONTRACT (1974).

cated to it was actually paid for other assets.[247] The court defended its rule by noting that the "taxpayers have it within their own control to choose in the first place whatever arrangements they care to make."[248]

In adopting its formal rule, the Third Circuit reaffirmed the Commissioner's right to challenge the form of the transaction.[249] The court expected such challenges "where a loss of tax revenues from one taxpayer cannot be retrieved entirely from another because of differentials in tax brackets or other factors . . . ."[250]

By drawing closer both to a formal approach and to the one-way rule, *Danielson* represented the next logical step in the journey that *Hamlin's Trust* and *Ullman* began. Whereas *Ullman* bound the taxpayer subject to a showing of strong proof, *Danielson* bound him subject to a showing of mistake, undue influence, duress, or fraud. From 1967 to 1980, however, the *Danielson* rule remained basically an anomaly, applied by one circuit to the single issue of the allocation of purchase price to a covenant not to compete.[251]

2. *Extension of Dispositive One-Way Rule Beyond Covenants Not To Compete*

In the 1980s, jurists became increasingly wary of determining economic reality and moved closer to formal interpretation of tax law. The proliferation of tax benefits unrelated to the measurement of income, such as the investment tax credit[252] and accelerated depreciation,[253] may have fueled this skepticism. Such benefits are incentives, intended to be allocated by private negotiation.[254] The tax

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247 *Danielson*, 378 F.2d at 774.

248 *Id*. at 775.

249 Where the Commissioner attacks the formal agreement the court involved is required to examine the 'substance' and not merely the 'form' of the transaction. This is so for the very good reason that the legitimate operation of the tax laws is not to be frustrated by forced adherence to the mere form in which parties may choose to reflect their transaction.

Id. at 774.

250 *Id*. at 778.

251 For an isolated extension of *Danielson*, see Estate of Rogers v. Commissioner, 445 F.2d 1020, 1022 (2d Cir. 1971) (applying strong proof rule in determining value of mortgage).

252 The investment tax credit was enacted in 1962. *See* Revenue Act of 1962, Pub. L. No. 87-834, 76 Stat. 963, § 2(b) (1962).

253 The accelerated cost recovery system was enacted in 1981. *See* The Economic Recovery Tax Act of 1981 (ERTA), Pub. L. No. 97-34, 95 Stat. 172, § 201(a) (1981).

254 See, for example, the provision regarding safe-harbor leasing enacted in 1981 and codified at I.R.C. § 168(f)(8) (1981). That provision was intended to permit loss corporations the full benefit of accelerated depreciation by transferring ownership in prop-

shelters sometimes resulting from such negotiations lack an economic reality apart from their tax consequences. Inundated by a flood of tax shelter cases, courts seized upon the one-way rule as a means of reducing their docket. In part, this meant strengthening that rule. Thus, four circuit courts of appeals replaced the strong proof rule with the more stringent *Danielson* rule.[255]

This also meant extending the strong proof and *Danielson* rules to a wide array of issues other than the allocation of purchase price to covenants not to compete. Some extensions were straight forward. For example, the preference for flexibility expressed in Subchapter K made it easy for the Fifth Circuit, in *Spector v. Commissioner*,[256] to adopt the *Danielson* rule in deciding whether a redemption of a partnership interest constituted a "sale"[257] or "liquidation,"[258] an issue which the court found lacking in economic reality.[259] Likewise, the careful bargaining involved in most business acquisitions made it natural to extend the strong proof and *Danielson* rules to allocations of purchase price to assets other than covenants not to compete, notwithstanding the easier severability and valuation issues posed by such assets.[260]

Other extensions of the strong proof and *Danielson* rules during phase three did not flow naturally from prior law. Courts applied the rules to many characterization issues not involving allocations and for which the statute did not contemplate a transactional approach. Courts used the rules when distinguishing between option payments and interest,[261] royalties and compensation,[262] sales and

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erty. *See* STAFF OF THE JOINT COMM. ON TAXATION, 97TH CONG., 1ST SESS., GENERAL EXPLANATION OF THE ECONOMIC RECOVERY TAX ACT OF 1981, at 103 (Comm. Print 1981).

[255] *See* Schatten v. United States, 746 F.2d 319, 321-22 (6th Cir. 1984); Bradley v. United States, 730 F.2d 718, 720 (11th Cir.), *cert. denied*, 469 U.S. 882 (1984); Spector v. Commissioner, 641 F.2d 376, 386 (5th Cir.), *cert. denied*, 454 U.S. 868 (1981); Forward Communications Corp. v. United States, 608 F.2d 485, 490 (Ct. Cl. 1979).

[256] 641 F.2d 376 (5th Cir.), *cert. denied*, 454 U.S. 868 (1981).

[257] I.R.C. § 741 (1991).

[258] I.R.C. § 736 (1991).

[259] *Spector*, 641 F.2d at 384 ("[O]nce the parties have agreed to structure the transaction in such a way as to comply with [statutory] requirement[s], 'economic reality' does not provide a ground upon which that form can be set aside.").

[260] *See* Sullivan v. United States, 618 F.2d 1001, 1006 (3d Cir. 1980) (*Danielson* rule applied to the allocation between lease and land); Dakan v. United States, 492 F.2d 1192, 1199 (Ct. Cl. 1974) (applying *Danielson* rule to allocation between capital and noncapital items).

[261] *See* Bradley v. United States, 730 F.2d 718, 720 (11th Cir.) (*Danielson* rule applied to determine whether amounts paid for a transfer of real estate constituted payments for a continuing option or interest income), *cert. denied*, 469 U.S. 882 (1984).

options,[263] and in making many other determinations.[264]

The most striking expansion of the one-way rule during the 1980s occurred for two issues on which courts had traditionally permitted the taxpayer to appeal to form. The first issue was the allocation of amounts paid under a divorce settlement agreement. Since *Landa v. Commissioner*,[265] courts had allowed taxpayers to appeal to the substance of such allocations.[266] Initially, courts expressed reluctance to apply the *Danielson* rule to settlement agreements because they are entered into by relatively unsophisticated persons who are likely to be under duress.[267] Nonetheless, in 1984 the Sixth Circuit applied the one-way rule to such transactions.[268]

The second issue was the effect of a sale-leaseback transaction on entitlement to the depreciation deduction. A series of cases replaced *Lazarus*' two-way rule[269] with the one-way rule. First, the Seventh Circuit, in *Comdisco, Inc. v. United States*,[270] cast a cloud over *Lazarus* by discussing the *Danielson* rule in the context of determining ownership of property for tax purposes.[271]

Later, in *Coleman v. Commissioner*,[272] the Tax Court went further. Acknowledging *Lazarus*, the court nonetheless appealed to the one-way rule to determine ownership of property for depreciation purposes: "We think it important to note that . . . it is the

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262 *See* Rothstein v. Commissioner, 90 T.C. 488, 495 (1988) (applying the strong proof rule to determine whether the proceeds from the sale of a business constituted royalties or compensation).

263 *See* Elrod v. Commissioner, 87 T.C. 1046, 1064-66 (1986) (discussion of strong proof and *Danielson* rules in distinguishing sale from option).

264 *See, e.g.*, Federal Nat'l Mortgage Ass'n v. Commissioner, 90 T.C. 405, 426-27 (1988) (one-way rule applied to a resale/refinance transaction), *aff'd*, 896 F.2d 580 (D.C. Cir. 1990), *cert. denied*, 111 S. Ct. 1619 (1991); Illinois Power Co. v. Commissioner, 87 T.C. 1417, 1430-32 (1986) (*Danielson* rule applied in characterizing corporate gift; form of the transfer respected); Miami Purchasing Serv. Corp. v. Commissioner, 76 T.C. 818, 830 (1981) (strong proof rule applied in determining where title passed in the sale and export of domestically produced goods); Franks v. Commissioner, 55 T.C.M. (CCH) 4,819 (1988) (applying the *Danielson* rule in determining whether amounts stated in sublease were income).

265 206 F.2d 431 (D.C. Cir. 1953).

266 *See supra* notes 173-76 and accompanying text.

267 *See, e.g.*, Weiner v. Commissioner, 61 T.C. 155, 160 (1973) (*Danielson* rule not applied to divorce settlement agreements).

268 *See* Schatten v. United States, 746 F.2d 319, 321-22 (6th Cir. 1984) (*Danielson* applied to divorce settlements).

269 *See supra* notes 220-22 and accompanying text.

270 756 F.2d 569 (7th Cir. 1985).

271 *Id.* at 578. The court rejected the *Danielson* rule because the formalities required for the investment tax credit precluded inconsistent taxpayer positions. *Id.*

272 87 T.C. 178 (1986).

taxpayer and not the Government which seeks to disavow the form of the transaction. . . . Although [*Lazarus*] ostensibly stands for the proposition that a taxpayer can attack the form of a transaction which encompasses the passage of title, there were various other factors present in that case. "[273] Later that term, the Tax Court again applied the strong proof rule to a sale-leaseback transaction.[274]

C. *Bargain and Whipsaw as Rationales for the One-Way Rule*

Under phase three, the rationales offered for the one-way rule reflected diminished faith in economic reality and movement toward a transactional approach. Emphasis on the transaction made the tax treatment of the parties interdependent and gave the IRS a stake in the arrangement.

Accordingly, during phase three, the favored volitional rationale for the rule was bargain. The agreement among private persons itself became a basis for taxation. Courts defended the strong proof rule as enforcing "agreements as made"[275] and as preventing "judicial alteration of a contract."[276] *Danielson* defended its rule as a means of enforcing private contracts:

> [T]he determination as to whether a covenant not to compete was actually executed is important, taxwise, both to the buyer and the seller. A tax challenge aside, the amount a buyer pays a seller for such a covenant, entered into in connection with a sale of a business, is ordinary income to the covenantor and an amortizable item for the covenantee. Indeed, the presumed tax consequences of the transaction may, as here, help to determine the total amount a purchaser is willing to pay for such a purchase. Therefore, to permit a party to an agreement fixing an explicit amount for the covenant not to compete to attack that provision for tax purposes, absent proof of the type which would negate it in an action between the parties, would be in effect to grant, at the instance of a party, a unilateral reformation of the contract with a resulting unjust enrichment. If allowed, such an attack would encourage parties unjustifiably to risk litigation after consummation of a transaction in order to avoid the tax consequences of their agreements. And to go behind the agreement at the behest of a party may also permit a party to an admittedly

[273] *Id.* at 201-03.

[274] *See* Illinois Power Co. v. Commissioner, 87 T.C. 1417, 1432-35 (1986).

[275] *See supra* note 242.

[276] *See* Major v. Commissioner, 76 T.C. 239, 247-48 (1981) (The strong proof rule is "necessitated by a general desire to instill a degree of predictability into this area of the law, as well as to guard against a flood of frivolous litigation in cases where one party seeks to obtain a judicial alteration of a contract . . . .").

> valid agreement to use the tax laws to obtain relief from an unfavorable agreement.
>
> Of vital importance, such attacks would nullify the reasonably predictable tax consequences of the agreement to the other party thereto. Here the buyer would be forced to defend the agreement in order to amortize the amount allocated to the covenant. If unsuccessful, the buyer would lose a tax advantage it had paid the selling-taxpayers to acquire. In the future buyers would be unwilling to pay sellers for tax savings so unlikely to materialize.[277]

By allowing the taxpayer to challenge the allocation of purchase price to a covenant not to compete only when he could also prove the covenant unenforceable, the Third Circuit essentially made the tax consequences of the allocation a matter of contract law. By allowing the IRS to invoke the parol evidence rule, *Danielson* virtually made the IRS a party to the contract.

Movement toward a transactional approach was also evident in the systemic rationale offered for the one-way rule. Focus on the transaction carried with it the corollary of consistent treatment. Thus, although the early strong proof cases did not make a systemic argument, one was eventually offered in *Danielson*, which emphasized the need to avoid whipsaw of the government:

> [Allowing taxpayers to attack the allocations set forth in agreements] would cause the Commissioner considerable problems in the collection of taxes. The Commissioner would not be able to accept taxpayers' agreements at face value. He would be confronted with the necessity for litigation against both buyer and seller in order to collect taxes properly due. This is so because when the Commissioner tries to collect taxes from one party he may, as here, dispute the economic reality of his agreement. When the Commissioner turns to the other party, there will likely be the arguments that the first party, as here, received consideration for bearing the tax burden resulting from the sale and that the covenants did indeed have economic reality.[278]

Although a latecomer, whipsaw eventually became the "most persuasive"[279] of the rationales for the one-way rule during phase three.

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[277] Commissioner v. Danielson, 378 F.2d 771, 775 (3d Cir.), *cert. denied*, 389 U.S. 858 (1967) (citation omitted).

[278] *Id.*

[279] Sullivan v. United States, 618 F.2d 1001, 1004 (3d Cir. 1980); *see also* Harvey Radio Lab., Inc. v. Commissioner, 470 F.2d 118, 120 (1st Cir. 1972) (emphasis on whipsaw and certainty as rationales for the strong proof rule).

PART THREE

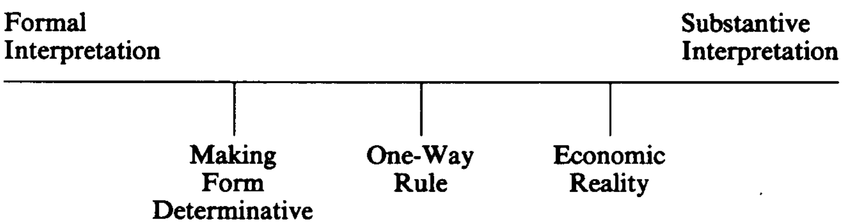
THE PRESENT STATUS OF THE ONE-WAY RULE

I

THE ONE-WAY RULE AS COMPROMISE

The present status of the one-way rule can be understood by considering the continuum between formal and substantive interpretation. As discussed above, formal interpretation looks only to the literal language of the statute or contract, while substantive interpretation permits departure from the language when necessary to reach a just result.[280] The one-way rule occupies an intermediate position on the continuum by adopting a formal interpretation in the immediate case while preserving the possibility of substantive interpretation in the future. On either side of the one-way rule lies a more formal alternative, making form determinative;[281] and a more substantive alternative, appeal to economic reality.[282] Thus the one-way rule compromises between these alternatives.

CHART TWO



II

THE CONTINUED VIABILITY OF THE ONE-WAY RULE IN THE FACE OF COMPETING ALTERNATIVES

As a compromise, the one-way rule competes with each of its alternatives. The rule recedes if economic reality or making form determinative become more attractive. Recent developments suggest that although economic reality and making form determinative may both be gaining in popularity, they are unlikely to eclipse the one-way rule.

280 *See supra* Part One I.C.
281 *See supra* note 229 and accompanying text.
282 *See supra* notes 29-36 and accompanying text.

A. *Economic Reality*

The traditional approach taxes individuals according to economic reality.[283] The prolific tax legislation of the 1980s may well revive faith in this approach. In many respects, the Economic Recovery Act of 1981,[284] the Tax Equity and Fiscal Responsibility Act of 1982,[285] the Deficit Reduction Act of 1984,[286] the Tax Reform Act of 1986,[287] and others,[288] reduced tax considerations in business planning. First, rate reductions in 1981[289] and 1986[290] decreased the marginal importance of taxes in overall profit. Second, the new laws curtailed tax preferences that diverge from economic income. Some, such as the investment tax credit, were repealed.[291] Others, such as accelerated depreciation, were limited selectively through the passive loss rules[292] and a strengthened minimum tax.[293] Finally, repealing safe-harbor leasing[294] and restricting partnership flexibility[295] curbed taxpayers' ability to allocate tax liability inter se.

These legislative changes may encourage courts to inquire into economic reality with renewed vigor. The reduced importance of tax incentives and of taxes generally should make courts more confident that commercial practice properly characterizes the parties' relationship. No longer crushed under a backlog of tax shelter cases,[296] courts have more leisure for extended analysis. Less often

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283 *See supra* Part One I.C.

284 ERTA, Pub. L. No. 97-34, 95 Stat. 172 (1981).

285 The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), Pub. L. No. 97-248, 96 Stat. 324 (1982).

286 The Deficit Reduction Act of 1984 (DEFRA), Pub. L. No. 98-369, 98 Stat. 494 (1984).

287 The Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (1986).

288 *See, e.g.*, the Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203, 101 Stat. 1330 (1987); the Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, 102 Stat. 3342 (1988); the Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, 103 Stat. 2106 (1989).

289 ERTA § 101.

290 Tax Reform Act of 1986 § 101.

291 *Id.* §§ 201-04, 211-13.

292 *Id.* §§ 501-02 (codified at I.R.C. § 469 (1991)).

293 *Id.* §§ 701-02 (codified at I.R.C. §§ 53, 55-59 (1991)).

294 TEFRA §§ 208-10 (repealing I.R.C. § 168(f)(8)).

295 *See* DEFRA §§ 71-79.

296 *See* 1989 I.R.S. ANN. REP. 60 (listing the number of refund suits and tax court cases pending in 1988 and 1989); 1988 I.R.S. ANN. REP., 35, 38-39 (listing the number of refund suits and tax court cases pending in 1987 and 1988); *see also Tax Report*, Wall Street J., August 22, 1990, at 1, col. 5 (describing 38% decline in Tax Court docket from 1986 to 1990).

required to defer to the parties' arrangement, courts will feel freer to delve into economic reality.

Notwithstanding its possible resurgence, the doctrine of economic reality seems unlikely to eclipse the one-way rule. Two premises underlie the one-way rule: a persistent skepticism about the existence of an independent economic reality[297] and a willingness to regard the parties' agreement as the touchstone of taxation.[298] These premises derive from basic perceptions that do not quickly fade and that mere legislation cannot alter.

This fact is evident in the history of the rule. Doubt regarding the economic reality underlying related-party sales dates from the 1940s and seems firmly entrenched.[299] Doubt with respect to other related-party transactions, while weaker, arose in the 1950s.[300] The movement from economic reality to transactional consistency evident in phase three[301] predates the tax shelters of the early 1980s and cannot be stemmed by legislative fiat.

B. *Making Form Determinative*

The formalist alternative to the one-way rule is the rule making form determinitive for both taxpayer and government. As did the one-way rule, this rule gained ground during phase three.[302]

The rule making form determinative responds to the premises underlying the one-way rule. Like the one-way rule, the rule making form determinative resolves doubt regarding economic reality in a way that provides certainty. Also like the one-way rule, the rule making form determinative adopts the transactional approach to taxation by effectively making the government a party to the transaction.

In contrast to the one-way rule, the rule making form determinative responds to the premises underlying the one-way rule so as to favor taxpayers. This alternative provides taxpayers, but not the government, with certainty. It allows taxpayers to allocate tax burden among themselves and assures them that the government cannot challenge the allocation. The rule making form determinative construes the statute *contra proferentem*,[303] against the preference

[297] *See supra* Part One I.D.
[298] *See supra* Part Two IV.A.2.
[299] *See supra* notes 84-93 and accompanying text.
[300] *See supra* notes 142-68 and accompanying text.
[301] *See supra* Part Two IV.A.
[302] *See supra* notes 223-28, 243 and accompanying text.
[303] *See supra* notes 37-38 and accompanying text.

of its author, the government.

In an era in which many advocate strictly construing constitutions and statutes,[304] the rule making form determinative may well gain popularity. Its appeal extends to Congress as well. In 1984, for example, Congress adopted a formal rule by making the designation of the parties determinative in distinguishing alimony from maintenance payments.[305] Less directly, the enactment of detailed schemes that lack commercial analogues, such as the passive loss rules,[306] may be read as presuming formal interpretation.[307]

However, it is unlikely that the rule making form determinative will ever completely subsume the one-way rule. Interpretative rules tend to be balanced, reflecting their use in a wide array of circumstances.[308] Thus, to the extent courts back away from economic reality, they will likely embrace both the rule making form determinative and the one-way rule. Indeed, recent tax legislation has reaffirmed and extended the *Danielson*[309] and strong proof[310] rules for allocating purchase price among business assets.[311]

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[304] *See, e.g.*, Easterbrook, *Statutes' Domains*, 50 U. CHI. L. REV. 533, 544-51 (1983) (arguing for strict construction); Wald, *The Sizzling Sleeper: The Use of Legislative History in Construing Statutes in the 1988-89 Term of the United States Supreme Court*, 39 AM. U.L. REV. 277, 281, 298 (1990) (describing a rise in the textualist approach to statutory construction).

[305] DEFRA § 422 (codified at I.R.C. § 71 (1991)). *See generally* Comment, *1984 Deficit Reduction Act: Divorce Taxation*, 1986 WIS. L. REV. 177.

[306] I.R.C. § 469 (1991).

[307] Prior to the Tax Reform Act of 1986, tax shelters were carefully analyzed for lack of a profit motive. *See, e.g.*, Rose v. Commissioner, 88 T.C. 386, 414-15 (1987), *aff'd*, 368 F.2d 851 (6th Cir. 1989). The enactment of the passive loss rules could be understood as undermining such substantive approaches.

[308] Blatt, *supra* note 29, at 844. *See* Llewellyn, *Remarks on the Theory of Appellate Decision and the Rules or Canons About How Statutes are to be Construed*, 3 VAND. L. REV. 395, 401-06 (1950) (setting forth conflicting maxims of interpretation).

[309] *See supra* notes 245-51 and accompanying text.

[310] *See supra* note 235 and accompanying text.

[311] The legislative history of the Tax Reform Act of 1986 reaffirmed the *Danielson* and strong proof rules. *See* STAFF OF THE JOINT COMM. ON TAXATION, 100TH CONG., 1ST SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, at 355 (Comm. Print 1987) (citing *Ullman* and *Danielson*); *id.* at 359 (acknowledging intent not to restrict IRS challenges to the value of assets).

The Omnibus Reconciliation Act of 1990 extended the *Danielson* rule to certain other allocations of purchase price. *See* I.R.C. § 1060(a) (1991) ("If in connection with an applicable asset acquisition, the transferee and transferor agree in writing as to the allocation of any consideration, or as to the fair market value of any of the assets, such agreement shall be binding on both the transferee and transferor unless the Secretary determines that such allocation (or fair market value) is not appropriate"); HOUSE COMM. ON WAYS AND MEANS, 101ST CONG., 2D SESS., LEGISLATIVE HISTORY OF WAYS AND MEANS DEMOCRATIC ALTERNATIVE, 79 (Comm. Print 1990) (describing

III

DIVISIONS WITHIN THE COMPROMISE

Assuming the one-way rule retains vitality, questions remain as to when and how courts will apply the rule. The compromise implicit in the one-way rule is not monolithic, but rather is based on the two premises discussed above: doubt regarding the existence of economic reality, and a willingness to make the transaction the touchstone for taxation. Although these premises were joined during phase three,[312] they are logically distinct and support different formulations of the one-way rule.

The case law recognizes this divergence. In *Strick Corp. v. United States*,[313] the Third Circuit rejected the *Danielson* rule in determining the excise tax due on sales among related parties because of the lack of adverse tax interests.[314] Nonetheless, the court bound the taxpayer to its form, presumably because of the doubtful economic reality of the transaction.[315] Conversely, in *Peerless Steel Equipment Co. v. Commissioner*,[316] the Tax Court refused to bind a corporation to the form of its transaction with its profit sharing plan, but nonetheless applied the strong proof rule.[317]

A. *Rule Based on Doubt Regarding the Existence of Economic Reality*

Courts viewing doubt regarding the existence of economic reality as the governing premise would apply the one-way rule whenever they have difficulty finding a standard by which to judge such reality. Under this premise, the rule receives heavy or light weight depending on the perceived level of difficulty. Conversely, a clear economic reality renders the rule inapplicable.

Courts adopting this premise generally equate economic reality with the practices of unrelated parties. If the parties are related, these courts attempt to construct economic reality from other bodies of law or from the statutory scheme. Some cases are resolved easily under this premise. Related-party transactions that Congress

provision as adopting the standards set forth in *Danielson*); H.R. REP. No. 101-964, 101st Cong., 2d Sess. 1096 (1990) (same).

312 *See supra* Part Two IV.A.

313 714 F.2d 1194 (3d Cir. 1983), *cert. denied*, 466 U.S. 971 (1984).

314 *Id.* at 1206.

315 *Id.*

316 26 T.C.M. (CCH) 880 (1967).

317 *Id.* at 883-84.

identified as lacking in economic reality[318] present the strongest case for applying the one-way rule. Conversely, arm's-length transactions provide the weakest case.

Other cases prove more difficult. Disagreement about the economic reality behind a "redemption," as defined in the Code,[319] may explain the difference between *Ciaio v. Commissioner*[320] and *Television Industries, Inc. v. Commissioner*.[321] Likewise, uncertainty over the weight to be attached to state law analogues for corporate existence may be at the heart of the disagreement between *Shaw v. Commissioner*[322] and *Bolger v. Commissioner*.[323]

B. Rule Based on Willingness to Make the Transaction the Focus of Taxation

In contrast, courts viewing the transactional approach to taxation as the guiding premise would find the core application of the one-way rule in unrelated-party transactions. By replacing taxation of individuals in accordance with economic reality with consistent taxation of the transaction, the transactional approach sanctions taxation contrary to an existing economic reality even if the means for determining such reality are clear. Namely, in relying on the contract price, both *Hamlin's Trust v. Commissioner*[324] and *Commissioner v. Danielson*[325] consciously departed from fair market value.[326]

The transactional approach is based on two separate theories. The broader theory holds that the parties should determine among themselves the tax consequences of their transactions. Under this theory, the one-way rule applies whenever the parties have adverse tax interests,[327] even if they cannot take inconsistent reporting positions.[328] Thus, this theory incorporates contract law standards into

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[318] *See, e.g.*, I.R.C. §§ 267, 482 (1991).

[319] I.R.C. § 317(b) (1991).

[320] 47 T.C. 447 (1967). *See supra* notes 151-53 and accompanying text.

[321] 284 F.2d 322 (2d Cir. 1960). *See supra* notes 155-56 and accompanying text.

[322] 59 T.C. 375 (1972). *See supra* notes 144-45 and accompanying text.

[323] 59 T.C. 760 (1973). *See supra* notes 146-47 and accompanying text.

[324] 209 F.2d 761 (10th Cir. 1954).

[325] 378 F.2d 771 (3d Cir.), *cert. denied*, 389 U.S. 858 (1967).

[326] *See supra* notes 236-37, 247 and accompanying text.

[327] *See* Atchison, Topeka and Santa Fe R.R. v. United States, 443 F.2d 147, 152 (10th Cir. 1971) (refusing to apply the *Danielson* and strong proof rules in determining tax treatment of bonds issued prior to 1913 because competing tax interests did not exist prior to enactment of income tax).

[328] *See* Harvey Radio Lab., Inc. v. Commissioner, 470 F.2d 118, 120 (1st Cir. 1972) (adopting the strong proof rule in situations not presenting the possibility for whipsaw).

federal tax law.

Under the narrower theory, the one-way rule applies only when the government might suffer whipsaw. The rule would not apply under this theory if legal formalities precluded whipsaw,[329] or if all parties to the transaction took consistent reporting positions,[330] or were before the court.[331] This theory elevates the taxpayer's burden of proof without necessarily incorporating contract law.

Case law illustrates the divergence of the two theories. In *Schmitz v. Commissioner*,[332] the Tax Court refused to apply the *Danielson* rule because both parties to the agreement were before the court, but nonetheless applied the strong proof rule.[333] Similarly, in *Illinois Power Co. v. Commissioner*,[334] the Tax Court, relying on the consistent reporting of the transaction, affirmatively allowed the taxpayer to appeal to economic reality,[335] while imposing a strong proof standard.[336]

The different theories for the transactional approach suggest that the one-way rule should receive more weight (the *Danielson* rule) when the possibility of inconsistent positions exists, and less weight (the strong proof rule) when the only reason for applying the rule is to encourage taxpayers to allocate tax consequences inter se.

C. *The Overall Effect of the Divisions*

In summary, the one-way rule presently consists of two branches. Under one branch, the one-way rule receives either preclusive or varying weight depending on the difficulty of finding a standard for judging economic reality.[337] Under the other, the one-way rule receives either great or intermediate weight depending on the potential for whipsaw.[338] Considered together, these branches clash.

Depending on the depth of the rifts between the premises, there

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329 *See* Comdisco, Inc. v. United States, 756 F.2d 569, 578 (7th Cir. 1985) (refusing to apply *Danielson* when the formal requirement for claiming investment tax credit precluded the possibility of whipsaw).

330 *See* Campbell v. United States, 661 F.2d 209, 217 (Ct. Cl. 1981) (suggesting that *Danielson* may not apply when inconsistent positions are not attributable to incompatible characterizations but to different accounting methods).

331 *See* Freeport Transp., Inc. v. Commissioner, 63 T.C. 107, 116 (1974) (refusing to apply *Danielson* when both parties to the agreement are before the court).

332 51 T.C. 306 (1968).

333 *Id*. at 317-18.

334 87 T.C. 1417 (1986).

335 *Id*. at 1433 & n.13.

336 *Id*. at 1434.

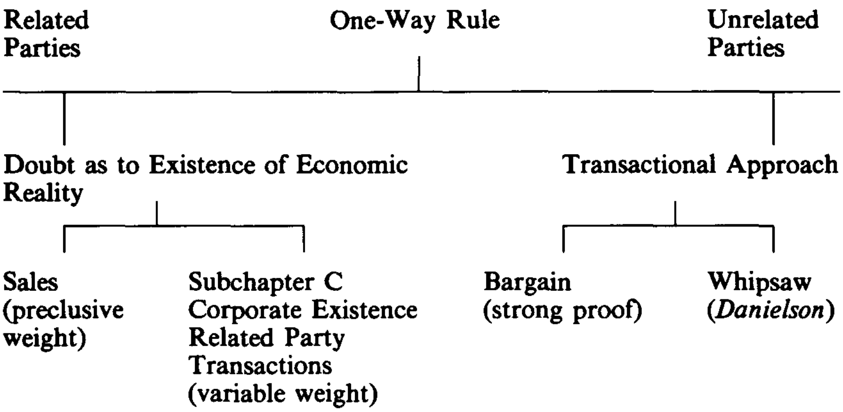
337 *See supra* Part Three III.A.

338 *See supra* Part Three III.B.

may be two one-way rules. One, premised on doubt regarding economic reality and concerned primarily with transactions among related taxpayers, places the taxpayer at the greatest disadvantage in challenging the character of related-party sales. The other, premised on the transactional approach and concerned with transactions among unrelated taxpayers, places the taxpayer at the greatest disadvantage when the government might be whipsawed.

These tensions may be diagrammed as follows:

CHART THREE



This description is a simplification. The rifts between the premises may not be as deep as it suggests, and many cases fall outside the pattern. For instance, the one-way rule sometimes receives variable weight in cases between unrelated parties, and the *Danielson* rule sometimes applies when no possibility of whipsaw exists.

PART FOUR

NORMATIVE CONSIDERATIONS FOR APPLYING THE ONE-WAY RULE

This Part offers normative considerations for applying the one-way rule. It first develops doctrinal guidelines for policymakers operating within present law categories. These guidelines constitute a unified approach to the one-way rule that is generally consistent with present law.

Part Four then undertakes a broader analysis, not limited by a doctrinal framework. By relating the rule to pervasive policy judgments, this analysis identifies the effects of the one-way rule, generates variables relevant to its adoption, and suggests alternative approaches for achieving its effect.

I

DOCTRINAL GUIDELINES FOR ADOPTING THE ONE-WAY RULE

Most jurists approach the one-way rule from existing doctrinal categories. These categories, consisting of the broader choices described in Part One, rest on two important assumptions: first, that economic reality is a viable means of resolving the choice between formal and substantive interpretation, and second, that the choices between strict and liberal construction and between deference and independent judgment are at least partially open.

These assumptions inhere in the one-way rule itself. The very formulation of the rule implies the existence of an economic reality to which the government could appeal were it dissatisfied with form. Likewise, complete acceptance or complete rejection of deference and liberal construction would obviate the role of the one-way rule.[339]

These two assumptions provide overarching guidelines for adopting the one-way rule. Under these guidelines, the rule should be adopted when there is both uneasiness over economic reality and a favorable inclination toward pro-government rules of interpretation. The formulation of the rule would depend upon the extent of such uneasiness and inclination.

A. *The Occasion for the One-Way Rule: Uneasiness Over Economic Reality*

Uneasiness over economic reality provides the occasion for the one-way rule: courts should not consider the rule unless they feel uneasy about determining economic reality. The history of the one-way rule illustrates this pattern. In each phase of its development, courts applied the rule when economic reality was least certain.[340]

This guideline synthesizes the two branches of the present one-way rule. It extends the branch based on doubt over the existence

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339 A system that always deferred to IRS determinations or routinely gave the tax law its broadest possible scope would not contain the one-way rule, because these broader principles would already assure a government victory. Conversely, the one-way rule would be incongruous in a system that never deferred to agency determinations and that always construed the tax law narrowly.

340 *See supra* notes 94-119, 139-79 and accompanying text.

of economic reality by applying the rule when an existent economic reality is factually difficult to determine. It contracts the branch based on a willingness to make the transaction the focus of taxation by giving weight to transactional consistency only if there is also uneasiness over economic reality.[341]

Despite its contraction of the phase three theory, this guideline is nonetheless consistent with most phase three cases. Phase three did, after all, coincide with growing doubt over economic reality.[342] Even phase three cases that knowingly departed from economic reality can be understood as responding to situations in which economic reality is difficult to determine. Under this understanding, *Ullman* and *Danielson* followed the contract allocation because of the generic difficulty of determining both the existence, and the value, of covenants not to compete.

1. Sources of Uneasiness

Uneasiness over economic reality has three potential sources. One is the deviation of the Code from the Haig-Simons definition of income.[343] The failure of the Code to tax accretions in wealth until realization, for example, deviates from that definition, which includes all income.[344] Likewise, if one considers the individual to be the appropriate taxable unit, imposing a separate corporate tax departs from the Haig-Simons norm.[345]

A second source of uneasiness springs from the absence of commercial norms for the transaction. Sometimes, no norm for the transaction can be found in other bodies of law, in the practice of unrelated parties acting at arm's length, or in the underlying statutory scheme. State law characterization may bear remote relevance to the policy of the tax provision, for example, and the parties may have negotiated the deal with its tax consequences in mind.

A third source of uneasiness is the factual difficulty of ascertaining economic reality. Even if it exists in theory, economic reality

341 Commentators are usually critical of the notion that consistency can provide a basis for taxation. *See* Wolfman, *supra* note 228, at 1098 (noting that the tax treatment of the person before the court should not be affected by the treatment of persons not before the court).

342 *See supra* notes 203-07 and accompanying text.

343 *See* H. SIMONS, *supra* note 34, at 50, 61-62, 206.

344 Simons accepted this deviation as an administrative necessity. *See id.* at 207 (calling abandonment of realization requirement "utter folly").

345 Thus, many economists favor integration of the corporate and individual income taxes. *See generally* C. MCCLURE, MUST CORPORATE INCOME BE TAXED TWICE? (1979).

may be difficult to ascertain. Determining fair market value, for example, can be troublesome, regardless of whether it is required for applying the Haig-Simons definition or interpreting the Code.

These sources can be illustrated by considering the tax treatment of the sale of an asset. Failure to tax the annual increase in the value of the asset gives rise to the first source of uneasiness. The second source of uneasiness is tapped whenever it is questionable whether the sale has occurred, such as when the transaction resembles a lease. The third source of uneasiness arises when the amount of gain recognized is uncertain because its determination depends upon the value of rarely traded property.

2. *Differing Levels of Uneasiness*

In a given fact situation, different jurists will feel varying degrees of uneasiness over economic reality. One important variable is how one defines that reality. A purist relying on the Haig-Simons definition of income, for example, would find an inquiry into economic reality meaningless for most transactions discussed in this Article because they involve either realization of income or imposition of corporate tax. Indeed, the failure of the Code to embody the Haig-Simons standard consistently casts doubt on whether economic reality exists for any transaction.[346] In contrast, a jurist defining economic reality by reference to commercial norms could find the inquiry into economic reality meaningful for most transactions.

The effect of one's definition of economic reality upon the one-way rule may be illustrated by comparing the limitation on capital losses[347] with the denial of losses on sales between related parties.[348] The limitation on losses seems premised on uneasiness attributable to the realization principle. Having failed to adopt accrual taxation, it may be fair to limit losses but not gains in order to address the problem of selective realizations. By contrast, the denial of losses on related-party sales seems premised on the assumption that such transfers lack commercial effect. Related parties do not behave in an arm's-length manner because they are indifferent as to the ownership of property among themselves.

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346 Once the base deviates from the Haig-Simons definition, one can never be certain that bringing a particular type of income into the base brings the entire system closer to the Haig-Simons ideal. This is the "theory of the second best." *See* A. ATKINSON & J. STIGLITZ, LECTURES ON PUBLIC ECONOMICS 569-70 (1980); Bittker, *A "Comprehensive Tax Base" as a Goal of Income Tax Reform*, 80 HARV. L. REV. 925, 983-84 (1967).

347 I.R.C. § 1211 (1991).

348 I.R.C. § 267 (1991).

3. *A Scale of Uneasiness*

Despite inevitable differences of opinion, we may construct a rough ranking of uneasiness by weighing various factors: the deviation of the tax treatment from the Haig-Simons norm, the relationship among the parties, the congressional intent, the availability of state law analogues, and the difficulty of the factual determination.

These factors suggest that uneasiness is great for transfers of hard to value property among commonly controlled corporations. Such transactions occur between related parties, are not subject to accrual taxation, and raise intractable factual issues. At the other extreme, uneasiness seems slight for most payments of cash wages to unrelated parties. Such payments constitute accretions in wealth under the Haig-Simons definition, conform to common practice, and are easily valued.

B. The Attraction of the One-Way Rule: Pro-Government Rules of Interpretation

Uneasiness over economic reality alone does not explain adoption of the one-way rule. Also necessary is the decision to adopt a pro-government rule of interpretation. By escalating the burden placed on the taxpayer, the one-way rule overtly favors the government. This pro-government tilt indicates that the long-term shift away from independent judgment and strict interpretation fueled the growth of the one-way rule over the three phases.[349]

The selection of the one-way rule does not necessarily imply a decision to forego more neutral alternatives. Without recourse to economic reality, the only alternative to a one-way rule is to make form determinative. Although facially neutral, that approach in practice favors the taxpayer, who controls the form. Thus, the only question may be the direction in which to tilt an inherently uneven playing surface.[350]

The attraction of pro-government rules of interpretation varies with context. Selective realization of losses, for example, may be more troubling than selective realization of gains.[351] A pro-govern-

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[349] Given the breadth of the deference/independent judgment and the strict construction/liberal construction choices, it is not surprising that cases considering the one-way rule seldom discuss those issues.

[350] Indeed, even economic reality has a pro-government flavor to the extent that it neutralizes the taxpayer's control of the facts.

[351] Thus the special rules for losses between related parties, wash sales, and capital losses. *See* I.R.C. §§ 267, 1091, 1231 (1991).

ment rule may also become more attractive when the taxpayer exercises unfettered control over form; e.g., the selection of form is unconstrained by unrelated persons or other bodies of law.

C. *The Form of the Rule: Weighing Uneasiness Over Economic Reality and the Attraction of Pro-Government Rules of Interpretation*

The exact form of the one-way rule depends on how uneasy courts feel about economic reality. Great uneasiness justifies a dispositive rule; less uneasiness supports reduced weight.

The form of the one-way rule also depends upon the attraction of pro-government rules of interpretation. Such rules may, for example, be attractive only insofar as the taxpayer controls the facts. Such reasoning could support binding the taxpayer to a form agreed upon with an unrelated party only if such form did not result from fraud or duress.

II

POLICY RAMIFICATIONS OF THE ONE-WAY RULE

The aforementioned guidelines are essentially doctrinal. They flow from a constellation of choices already made in the legal system. Addressed to the policymaker who reasons by analogy from existing legal categories, they do not challenge the policy decisions built into those categories. So confined, they do not aid one operating from a clean slate.

In order to assess the merits of the one-way rule de novo, one must consider the policy judgments implicit in the doctrinal framework. At least three such judgments deserve consideration. Logically independent, each judgment coincides with what Jack Balkin describes as a separate axis in the law[352] and is associated with a broader choice described in Part One.[353] With respect to each choice, the one-way rule constitutes a middle ground.

The first judgment involves the trade-off between formal and sub-

[352] *See* Balkin, *supra* note 13, at 41 n.68 (describing tax law as involving several axes).

[353] Each policy judgment constitutes an idealized effect of a legal rule that exists independently of a particular context. A real world doctrinal choice invariably implicates two or more axes. *See id.* at 45-62 (describing relationship among axes). Deference to the Internal Revenue Service will, for example, more often than not impose liability. Similarly, formal interpretation usually favors the taxpayer, who structures the transaction.

stantive decisionmaking:[354] whether a particular issue is best addressed by a formal rule or a substantive standard. This judgment underlies the choice between formal and substantive interpretation. Under this choice, the rule compromises between economic reality and making form determinative.

The second policy judgment concerns the allocation of lawmaking authority among competing institutions:[355] whether (and to what extent) a determination belongs to the judicial, executive, or legislative branch. This judgment surfaces in the choice between deference and independent judgment. For this choice, the one-way rule occupies an intermediate position because it reduces the weight attached to certain taxpayer arguments.

The third policy judgment relates to the imposition of tax liability:[356] whether a tax should be imposed as a result of a particular transaction. This judgment arises when courts choose between strict and liberal construction. The one-way rule constitutes a middle ground with respect to such a choice because in limited situations it broadens the statute.

Considering the relationship of these three judgments to the one-way rule reveals its potential effects, thereby paving the way for its ultimate evaluation. That evaluation falls beyond the scope of this Article, however, because those effects are highly contextual and raise empirical issues.

Notwithstanding this limitation, analyzing the relationship of the rule to the underlying policy judgments frames issues for future resolution. Such analysis also identifies variables which are useful in considering when and how to adopt the one-way rule. Finally, the analysis suggests potential alternatives that achieve some of the rule's effect without revisiting the broader choices.

A. The Trade-Off Between Formal and Substantive Decisionmaking

The first policy judgment involves the trade-off between formal and substantive decisionmaking. Formal decisionmaking restrains official arbitrariness, conserves judicial resources, and provides certainty. Substantive decisionmaking offers precision in applying the

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354 *See id.* at 43-45 (describing the opposition between formal and substantive realizability).

355 *See id.* at 42-43 (institutional authority as a separate axis of opposition).

356 This judgment is a subset of the broader opposition between individualism and communalism. *See supra* text accompanying note 39.

tax statute.[357]

The one-way rule promises the best of both formal and substantive decisionmaking. The rule restricts official arbitrariness by reducing judicial discretion in cases in which the taxpayer challenges the form of the transaction. It also conserves judicial resources by constituting a formally realizable rule in such situations. Moreover, it provides certainty to private actors by assuring them that other parties to the agreement will be bound for tax purposes, thereby lessening the likelihood of an IRS challenge. Finally, the rule provides certainty to the IRS by reducing the likelihood of inconsistent taxpayer positions. While achieving these objectives of formal decisionmaking, the one-way rule preserves the possibility of more precise substantive decisionmaking in the future.

None of these advantages is assured. Erratic application of the one-way rule itself could well increase judicial arbitrariness, dissipate judicial resources, and create uncertainty, while forfeiting the precision of substantive decisionmaking. Even consistent application of the rule has uncertain impact. For example, whether the rule conserves judicial resources depends upon whether using the rule in the immediate case outweighs the confusion that will arise in future cases.[358]

The trade-off between formal and substantive decisionmaking suggests variables useful in considering the one-way rule. One is the need for precise results. This need for precision varies with the availability of a fair and objective standard, i.e., economic reality.

Another variable is the need for certainty. A private actor's need for certainty depends upon the nature of the transaction. Such need peaks for unrelated-party transactions negotiated in expectation of particular tax consequences.[359] Such need diminishes when the parties are related or when mistake, undue influence, fraud, or duress render the contract unenforceable. By contrast, the Commis-

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[357] For further description of these trade-offs, see Kennedy, *supra* note 26, at 1687-1701; Ehrlich & Posner, *An Economic Analysis of Legal Rulemaking*, 3 J. LEGAL STUD. 257 (1974).

[358] Unnecessary appeal to pedigree when form would control in any event wastes judicial resources by needlessly encouraging future government challenges to form. Thus, several commentators criticize courts for using the rule as a crutch when form would have been determinative anyway. *See* Note, *Anodyne*, *supra* note 245, at 1330-33 (criticizing invocation of *Danielson* when government would prevail on merits); Smith, *supra* note 3, at 141-43 (distinguishing one-way rule from claim that form controls for tax purposes).

[359] *See*, for example, the description of Subchapter K contained in Foxman v. Commissioner, 41 T.C. 535 (1964). *See supra* notes 208-09 and accompanying text.

sioner's need for certainty increases with the possibility that the parties will successfully take inconsistent positions.[360]

The trade-off between formal and substantive decisionmaking suggests alternative means of providing certainty. Liberalized rules of intervention and joinder[361] would, for example, eliminate whipsaw of the government and conserve judicial resources while permitting an inquiry into economic reality. Expanding the mitigation provisions of the Code[362] would have the same effect while preventing whipsaw of taxpayers. Other alternatives include imposing a duty of consistency, which prevents a taxpayer from changing a return position,[363] and adopting the tax benefit rule, which prevents a single taxpayer from taking inconsistent positions for different years.[364]

B. Allocation of Law-Making Authority

The second policy judgment entails the allocation of law-making authority between the IRS and the courts. This allocation depends upon the relative advantage of judicial review—weighing the potential gain in legality and legitimacy associated with independent judicial review against the low cost and technical expertise of agency determination.[365]

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360 As is evident in the text, certain facts have an ambiguous effect on the desirability of the one-way rule. The presence of unrelated parties, for example, makes economic reality potentially more meaningful while also increasing the need for certainty.

361 *See* Lake, *supra* note 216, at 885-92.

362 I.R.C. §§ 1311-1314 (1991).

363 The taxpayer's duty of consistency estops the taxpayer even when the technical elements of estoppel are absent. According to the Tax Court, this "quasi-estoppel" applies if: "(1) the taxpayer has made a representation or reported an item for tax purposes in one year, (2) the Commissioner has acquiesced in or relied on that fact for that year, and (3) the taxpayer desires to change the representation, previously made, in a later year after the statute of limitations on assessments bars adjustments for the initial tax year." Unvert v. Commissioner, 72 T.C. 807, 815 (1979) (quoting Beltzer v. United States, 495 F.2d 211, 212 (8th Cir. 1974)); *see* Alamo Nat'l Bank of San Antonio v. Commissioner, 95 F.2d 622 (5th Cir.), *cert. denied*, 304 U.S. 577 (1938).

364 I.R.C. § 111 (1991). *See generally* Del Cotto & Joyce, *Double Benefits and Transactional Consistency Under the Tax Benefit Rule*, 39 TAX L. REV. 473 (1984); White, *An Essay on the Conceptual Foundations of the Tax Benefit Rule*, 82 MICH. L. REV. 486 (1983).

365 *See* Diver, *supra* note 19, at 574-92; Sunstein, *On the Costs and Benefits of Aggressive Judicial Review of Agency Action*, 1989 DUKE L.J. 522, 522-26 (describing the benefits of aggressive agency review).

The allocation of law making authority may also be influenced by judgments involving the trade-off between formal and substantive decisionmaking. If crafting precise formal rules is more expensive than drafting substantive standards, then deference to the Commissioner may be justified as a means of reducing drafting costs. *Cf.* Landes &

The one-way rule trades off between these competing policies. It limits the independence of judicial review by making the result dependent upon the Commissioner's litigation position. The extent of this limitation depends upon the weight given to pedigree. If taxpayers are absolutely precluded from appealing to form, the deference to IRS position is great. If taxpayers face only a higher burden of proof, the deference is less.

The allocation of law making authority suggests factors for applying the one-way rule. One factor is the congressional intent regarding the scope of review.[366] This factor probably explains why the explicit reference to the Secretary in Code section 482[367] is read to forbid taxpayer challenges to form.

Another factor is the relative expertise of court and agency.[368] The IRS has a deeper familiarity with the Code than most courts. Thus, other things being equal, the IRS has a stronger claim to deference in interpreting statutory terms of art governing corporate distributions and adjustments than in construing concepts like sale and lease, which have common law analogues.[369]

The policies regarding allocation of law making authority suggest alternative means of deferring to the Commissioner. Giving weight to IRS rulings and regulations defers to the Commissioner's interpretations of law.[370] Similarly, granting assessments the presumption of correctness[371] and placing the burden of proof on the taxpayer[372] defers to the Commissioner's factual findings.

Posner, *The Private Enforcement of Law*, 4 J. LEGAL STUD. 1, 38-41 (1975) (arguing that discretionary nonenforcement of over-inclusive statutes may be less costly than more precise drafting).

366 *Cf.* Ford Motor Credit Co. v. Milhollin, 444 U.S. 555, 557, 568 (1980) (according an agency a "high degree of deference" because of congressional intent for administrative decision). It is well established that Congress may preclude judicial review entirely. *See* Southern Ry. v. Seaboard Allied Milling Corp., 442 U.S. 444, 454 (1979); Morris v. Gressette, 432 U.S. 491, 501 (1977); Abbott Lab. v. Gardner, 387 U.S. 136, 140 (1967), *overruled on other grounds*, Califano v. Sanders, 430 U.S. 99, 105 (1977).

367 I.R.C. § 482 (1991). *See supra* text accompanying notes 91-93.

368 *Cf.* Diver, *supra* note 19, at 589-90 (describing need for statutory harmony).

369 Although federal tax law governs the determination of whether a transaction gives rise to a sale, such determination is made by reference to various state law concepts, such as passage of title and the allocation of the burdens and benefits from the property. *See* Frank Lyon Co. v. United States, 435 U.S. 561, 589 (1978); text accompanying note 226 *supra*.

370 *See* 1 J. MERTENS, *supra* note 61, §§ 3.46-3.47.

371 *See* Welch v. Helvering, 290 U.S. 111, 115 (1933).

372 *See generally*, Martinez, *supra* note 25 (discussing policy basis for allocating burden of proof in tax cases).

C. Imposition of Tax Liability

The third policy judgment involves the imposition of tax liability. Broadly considered, this judgment entails determining the relative size of the private and public sectors of the economy. More narrowly considered, the judgment is whether a particular person should pay tax. From this narrow perspective, the one-way rule is an immediate choice for the fisc.[373]

Determining whether a given person should pay tax depends in part upon the appropriate overall level of taxation, or subsidy, whichever the case may be. The willingness to allow a taxpayer to appeal to substance in order to fully utilize the benefits of accelerated depreciation might, for example, depend on the appropriate level of subsidy for the industry. Just as tax benefits are restricted to persons who materially participate in a business,[374] so also might such benefits be limited to persons for whom form matches substance. Weighing the merits of such a "selective" limitation requires a second-best analysis.[375]

Another consideration in imposing tax liability is the utility of the taxpayer's activity. Rules governing liability in unclear situations may be viewed as allocating the risk of uncertain tax consequences. If the taxpayer's activity benefits society, imposing tax when the statute is unclear may be unduly burdensome. Spreading the cost of legal uncertainty over society at large by not imposing liability may be more efficient. If the taxpayer's activity does not benefit society, imposing liability becomes more appropriate.

Assessment of social utility depends largely upon defining the "activity" being taxed.[376] Also important is the social utility of any non-tax rule giving rise to the form. For example, the decision to

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373 The effect of the one-way rule on the relative size of the public sector is unclear. Its short-term, static effect increases receipts, but its long-term dynamic effects may be otherwise. If generally perceived as unfair, the rule may decrease overall revenue because of the resulting noncompliance. Moreover, any increase in receipts attributable to the rule might be lost through future compensating rate adjustments.

374 See the passive loss rules, I.R.C. § 469 (1991). *See also* JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, at 212 (1987) ("Congress determined that, in order for tax preferences to function as intended, their benefit should be directed primarily to taxpayers with a substantial and *bona fide* involvement in the activities to which the preferences related.").

375 *See* Shaviro, *Selective Limitations on Tax Benefits*, 56 U. CHI. L. REV. 1189 (1989). Professor Shaviro concludes that "[t]he principal fairness and efficiency gain that could result from selective limitations is a reduction in the quantity of tax-favored investment." *Id*. at 1259-60.

376 The social benefit from a reorganization, for example, may vary considerably depending on whether the underlying "activity" is in compliance with the requirements of

disregard, for corporate tax purposes, a corporate agent formed in order to avoid state usury laws[377] undermines those laws. Likewise, allowing a bank that side steps regulatory restrictions on investment in real property to benefit indirectly from depreciation deductions on the property[378] sanctions such behavior.[379]

The policy judgment regarding tax liability suggests several alternatives to the one-way rule. Some rules address the level of subsidy. A legislative cap on the benefit to be derived from the tax subsidy directly addresses this issue.[380] A less direct means of reducing the subsidy is the rule construing tax exemptions narrowly.[381]

Other alternatives look to the utility of the taxpayer's activity. A close cousin of the one-way rule is a test that looks to motive, by requiring the presence of business purpose[382] or the absence of tax avoidance.[383] That test assists in the determination of tax liability by distinguishing beneficial from nonbeneficial behavior. Insofar as it constitutes an extra requirement that the taxpayer alone must satisfy, such a test resembles the one-way rule.

CONCLUSION

The seemingly simple one-way rule is in fact immensely complex. The rule has a richness that is belied by the brief, formulaic statements contained in the case law. This Article explores that richness by placing the rule in legal and historical context. Hopefully, this exploration will result in deeper understanding.

Code section 368(a)(1), the consolidation of businesses, or the activities in which the merging corporations are engaged. *See* I.R.C. § 368(a)(1) (1991).

377 *See* Bolger v. Commissioner, 59 T.C. 760 (1973).

378 This may have been the case in Frank Lyon Co. v. United States, 435 U.S. 561 (1978), where the federal and state banking laws substantially restricted bank investment. Nonetheless, by paying lower rent, the bank benefitted from the depreciation allowed the lessor. This is evidenced in the fact that the best possible return the lessor could have expected was 6%, while the more senior creditor earned 6.75%. *Id.* at 567-68.

379 More generally, allowing parties to allocate tax consequences *inter se* depends upon whether a contract properly allocates those consequences. *See supra* note 268 and accompanying text (noting uneven bargaining power in divorce settlements).

380 *See* I.R.C. § 42(h) (1991) (allocation of low income housing credit by state housing agencies); I.R.C. § 146(b) (1991) (volume cap on private activity bonds).

381 *See* 1 J. MERTENS, *supra* note 61, § 3.33; 3A J. SUTHERLAND, *supra* note 16, § 66.09.

382 *See, e.g.*, Gregory v. Helvering, 293 U.S. 465 (1935).

383 *See supra* text accompanying notes 121-28.