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Helvering v. Gregory: All the Perspectives from which Learned Hand Was Wrong

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HELVERING V. GREGORY: ALL THE PERSPECTIVES FROM WHICH LEARNED HAND WAS WRONG

*Anthony P. Polito**

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When a judge tries to find out what the government would have intended which it did not say, he puts into its mouth things which he thinks it ought to have said, and that is very close to substituting what he himself thinks right. – Learned Hand¹

I. INTRODUCTION

*Helvering v. Gregory*² is one of the great old chestnuts of American tax law. In it Judge Learned Hand and the Second Circuit created and imposed on the tax treatment of corporate reorganizations a “business purpose” requirement that appeared nowhere in the act of Congress that

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1. LEARNED HAND, *THE SPIRIT OF LIBERTY* 108 (Irving Dillard ed., 3d ed. 1960).
2. *Helvering v. Gregory*, 69 F.2d 809, 810 (2d Cir. 1934).

he was purporting to interpret. At a very deep level, that decision was predicated on an assumption that the normal taxation of corporate investments was full double taxation, under which all earnings in corporate form are subject to taxation inside the corporation and then to separate independent taxation at the investor level. Hand stated this predicate explicitly in his opinion.³ It is a necessary predicate to justify the wholesale creation of a business purpose requirement, whose purpose was to reinforce that double-tax regime.

His decision reversed a Board of Tax Appeals decision applying a literal reading of the statute.⁴ In contrast to Hand's view of the matter, there are three distinct and important perspectives of the matter that lead to a conclusion that the literal reading of the statute would have produced the better result. None of these depends on literalism for its own sake.

An Integrationist Perspective takes the view that double taxation is problematic because of the distortions to allocative efficiency and distributive equity that it generates.⁵ Integrationism would exactly eliminate the excess burden of double taxation and the economic and distributive distortions that double taxation entails. In the case of Evelyn Gregory's transactions, the literal application made it possible in particular situations of advancing the goals of the Integrationist Perspective. She had found a statutory escape hatch from double taxation, and Hand's opinion had the counterproductive effect of unnecessarily sealing that escape hatch.

Second, even within a double-tax regime, it is even more difficult to justify multiple levels of taxation.⁶ Gregory's escape hatch also made it possible, at a minimum, to bypass an even more unjustifiable third, or further, level of tax. Yet, Hand's opinion unnecessarily and counterproductively blocked that route as well.

Third, from a consumption tax perspective the direct rollover from one investment into another should not trigger taxation.⁷ The literal application of the reorganization provisions to Gregory's transactions

3. *Id.*

4. *Gregory v. Comm'r.*, 27 B.T.A. 223 (1932).

5. See Anthony P. Polito, *Advancing to Corporate Tax Integration: A Laissez-Faire Approach*, 55 S.C. L. REV. 1, 6-29 (2003).

6. See, e.g., Daniel C. Schaffer, *The Income Tax on Intercorporate Dividends*, 33 TAX LAW. 161 (1979).

7. See, e.g., William D. Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113, 1165 (1974) [hereinafter Andrews, *Consumption Tax*]; William D. Andrews, *Fairness and the Personal Income Tax: A Reply to Professor Warren*, 88 HARV. L. REV. 947 (1975).

had this effect. From that perspective as well, Hand's opinion had a counterproductive effect.

Each of these perspectives faces that objection that they are not the perspectives of the tax law, that the tax law is not the enactment of pure consumption taxation or integrationism and even tolerates multiple taxation in many cases. Neither, however, was the tax law what Hand assumed, the enactment of his own assumed norm, double income taxation of corporate earnings. When each of these contrasting perspectives is examined, it becomes apparent that U.S. tax law is, and always has been, a careful complicated compromise among competing views of sound taxation. The manifestation of that compromise is the statutory language itself.

Nor was Gregory's case one in which a gap in the statute left the legal question unanswered, which would have required the court to go beyond the text of the statute in order to supply the needed answer.⁸ The literal application of the statute did provide an answer. It was simply one that Hand found inconsistent with his own view of the overriding norm of taxation. As observed by the Board of Tax Appeals in its examination of Gregory's transaction, "A statute so meticulously drafted must be interpreted as a literal expression of the taxing policy"⁹

This raises the most important perspective from which Hand's opinion was mistaken. By taking his own preferred view of taxation as the overriding norm, he ignored the other perspectives that went into the legislative compromise. In effect, he set aside the deal made in Congress to favor his own preferred view. Given a statute that reflects a delicate compromise among competing policy perspectives, the best evidence of the proper interpretation of the compromise is the language of the statute itself. From this perspective the literal application of the statutory language was the appropriate course for an interpreting court because it was the most faithful way to implement that compromise.

At a fundamental level, this Article is about interpretation. The best way for a court to remain faithful to a complicated statute reflecting a delicate legislative compromise is to enforce its language literally without introducing extraneous tests or elements that cannot be found in

8. A classic statement of this point is owed to Justice Holmes: "I recognize without hesitation that judges do and must legislate, but they can do so only interstitially . . ." *S. Pac. Co. v. Jensen*, 244 U.S. 205, 221 (1917) (Holmes, J., dissenting). It was only within these interstices that Justice Holmes recognized a legitimate scope for courts "to exercise the sovereign prerogative of choice." Oliver W. Holmes, *Law in Science and Science in Law*, 12 HARV. L. REV. 443, 461 (1899).

9. *Gregory v. Comm'r*, 27 B.T.A. 223, 225 (1932).

the statutory language. Yet, it is important to be clear that it approaches the question from an *ex ante* perspective, from where things stood before Learned Hand's famous opinion.

This Article is not a call for the judicial reversal of Hand's opinion. Given the value of the predictability of established expectations as to statutory meaning, *stare decisis* is at its strongest when applied to statutory interpretation. As Justice Brandeis observed:

Stare decisis is usually the wise policy, because in most matters it is more important that the applicable rule of law be settled than that it be settled right. This is commonly true even where the error is a matter of serious concern, provided correction can be had by legislation.¹⁰

The business purpose requirement is now reflected in a Treasury Regulation¹¹ that is entitled to a high degree of deference.¹² Congress has had multiple opportunities to eliminate it and has not so done.¹³

No, this Article is not an argument for the judicial reversal of a familiar old decision. It advances the claim that, as of the time the court faced the decision, the outcome it selected was incorrect from multiple policy perspectives and therefore a counterproductive exercise of the interpretive authority. Moreover, at the time decided, it was a mistaken use of the interpretive authority to upset a carefully set legislative compromise in favor of the court's own preferred outcome.

Before proceeding, a further caveat is necessary. Although the Supreme Court upheld Hand's opinion unanimously,¹⁴ this Article focuses primarily on Hand's opinion for the Second Circuit for good reasons. His is the more frequently quoted of the two opinions. His opinion is the more extensive of the two. It sets out more thoroughly the justification for creating a business purpose requirement, while the Supreme Court opinion largely relies on its reference to Hand's opinion.¹⁵

10. *Burnet v. Coronado Oil & Gas Co.*, 285 U.S. 393, 406 (1932) (Brandeis, J., dissenting) (citations omitted).

11. Treas. Reg. §1.368-1(c) (2011).

12. *See Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837, 842-45 (1984) (recognizing a high degree of deference to an administrative agency when it is interpreting a statute within the scope of its authority); *Mayo Found. for Med. Educ. and Research v. U.S.*, 562 U.S. ___, 131 S. Ct. 704, 711-14 (2011) (applying *Chevron* to Treasury Regulations).

13. *See, e.g., Cottage Sav. Ass'n v. Comm'r*, 499 U.S. 554, 561 (1991); *Lorillard v. Pons*, 434 U.S. 575, 580 (1978); *United States v. Correll*, 389 U.S. 299, 305-06 (1967); *Helvering v. Winmill*, 305 U.S. 79, 83 (1938).

14. *Gregory v. Helvering*, 293 U.S. 465 (1935).

15. *Gregory*, 293 U.S. at 469 ("The reasoning of the court below in justification of a negative answer leaves little to be said.").

II. THE TRANSACTION AND HAND'S TAX TREATMENT OF IT

The facts and circumstances of Evelyn Gregory's transaction are well known to those well-versed in the history of U.S. corporate taxation but bear a brief repetition here. In 1928, Evelyn Gregory owned all of the outstanding stock of United Mortgage Corporation ("United"), purchased between October 1, 1920, and January 3, 1928. Her combined basis in that stock was \$350,000.¹⁶ Among its assets, United held 1,000 shares of Monitor Securities Corporation ("Monitor"), which it purchased in 1922 at a cost of \$10,413.07.¹⁷

Gregory determined to dispose of the Monitor stock in a tax efficient manner. Therefore, Averill Corporation ("Averill") was organized under Delaware law on September 18, 1928, and on September 20, the Monitor stock was transferred to Averill. In exchange, Averill issued it shares to Gregory. This spin-off transaction was structured to take advantage of the reorganization provision of the Revenue Act of 1928, which provided that:

The term "reorganization" means (A) a merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or substantially all the properties of another corporation), or (B) *a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its stockholders or both are in control of the corporation to which the assets are transferred*, or (C) a recapitalization, or (D) a mere change in identity, form, or place of organization, however effected.¹⁸

The equivalent spin-off transaction under the contemporary Internal Revenue Code would be termed a divisive-D reorganization.¹⁹ Congress has since adopted additional requirements for such a transaction to qualify as a reorganization,²⁰ qualifying requirements that Gregory's transaction would not have satisfied.

Gregory reported no gain on the transaction²¹ and apportioned her original basis in the United stock to the Averill stock in proportion to its

16. Gregory v. Comm'r, 27 B.T.A. 223, 224 (1932).

17. Brief for Respondent at 3, Gregory v. Helvering, 293 U.S. 465 (1935), available at 1934 WL 60141.

18. Revenue Act of 1928, ch. 852, § 112(i), 45 Stat. 791, 818 (1927-1929) (emphasis added).

19. I.R.C. § 368(a)(1)(D) (2012).

20. I.R.C. § 355 (2012).

21. Revenue Act of 1928, § 112(g), 45 Stat. at 818.

value relative to the remaining value of the United stock.²² Thus, immediately after the spin-off, her basis in the Averill stock was \$57,325.45, and her remaining basis in the United stock was \$292,674.55.²³ Reorganization treatment also made the transaction non-taxable to United.²⁴

On September 24, Averill Corporation liquidated and distributed its sole asset, the Monitor stock, to Gregory.²⁵ Gregory reported gain upon the liquidation of Averill in the amount of \$76,007.88, calculated as \$133,333.33 (the fair market value of the Monitor stock)²⁶ less \$57,325.45 (the apportioned basis in her Averill stock).²⁷ Averill recognized no gain or loss on its liquidating distribution.²⁸ Gregory took a fair market value basis in the Monitor stock, and therefore recognized no further gain or loss on its sale the same day as the liquidation for \$133,333.33.²⁹ She treated most of the gain as capital gain taxable at preferential rates,³⁰ but only in the same proportion that the holding period for her United stock was more than two years.³¹ Thus, according to Gregory's characterization, there was no corporate level tax and the single shareholder-level tax was primarily imposed at capital gain rates.

In contrast to this literal application of the Revenue Act of 1928's explicit language to Gregory's transactions, Judge Learned Hand posed an alternative hypothetical transaction that would have been subject to very different tax treatment.

In 1928 it became possible to sell the Monitor shares at a large profit, but if this had been done directly, the United Mortgage Corporation would have been obliged to pay a normal tax on the resulting gain, and the taxpayer, if she wished to touch her profit, must do so in the form

22. Revenue Act of 1928, § 113(a)(9), 45 Stat. at 820.

23. *Gregory v. Comm'r*, 27 B.T.A. 223, 224 (1932); Brief for Pctitioner at 4, *Gregory v. Helvering*, 293 U.S. 465 (1935), available at 1934 WL 60333.

24. Revenue Act of 1928, § 112(b)(4), 45 Stat. at 816.

25. *Gregory v. Comm'r*, 27 B.T.A. at 224.

26. *Id.* at 224. (the value of the Monitor stock was determined based on its sale price on the same day).

27. *Id.* See also Revenue Act of 1928, §§ 111(a), 115(c), 45 Stat. at 815, 822.

28. See Treas. Reg. § 45, art. 547 (1919), reprinted in 134 UNITED STATES REVENUE ACTS 1909-1950, 140 (Bernard D. Reams, Jr. ed., 1979) ("No gain or loss is realized by a corporation from the mere distribution of its assets in kind upon dissolution, however they may have appreciated or depreciated in value since their acquisition.").

29. *Gregory v. Comm'r*, 27 B.T.A. at 224.

30. Revenue Act of 1928, § 101, 45 Stat. at 811-12.

31. Of Gregory's 5,000 shares of United stock, 3,300 shares had a holding period of more than two years. Therefore, 66 percent of her gain was long-term capital gain. *Gregory v. Comm'r*, 27 B.T.A. at 226.

of a dividend, on which a surtax would have been assessed against her personally.³²

In Hand's view it is clear that the normative treatment is double taxation, once at the corporate level and again at the shareholder level, and that the shareholder level tax normatively ought to be at the dividend rate. Hand clearly sees the transaction as escaping one level of taxation entirely and improperly converting the second level of tax from "normative" dividend taxation to preferential capital gain taxation.

It is from this starting point that he creates and imposes a requirement that a valid reorganization must serve an independent business purpose other than the minimization of taxes, even though no such requirement appears anywhere in the statute. Hand asserts that:

Nevertheless, it does not follow that Congress meant to cover such a transaction, not even though the facts answer the dictionary definitions of each term used in the statutory definition. It is quite true, as the Board has very well said, that as the articulation of a statute increases, the room for interpretation must contract; but the meaning of a sentence may be more than that of the separate words, as a melody is more than the notes, and no degree of particularity can ever obviate recourse to the setting in which all appear, and which all collectively create.³³

He proceeds to conclude that the "melody" here is that a transaction satisfying all of the statutory requirements of being a reorganization is nevertheless not one unless motivated by a business purpose.³⁴ Therefore, Gregory received a dividend distribution, whether of the Averill stock or of the Monitor stock,³⁵ in an amount of \$133,333.33.³⁶

Although the tax treatment of United was not before Hand's court, it seems clear that from his perspective the normal treatment is that it

32. Helvering v. Gregory, 69 F.2d 809, 810 (2d Cir. 1934).

33. *Id.* at 810-11.

34. *Id.* at 811.

35. *Id.*

36. The full amount of the distribution would be a dividend only if United's earnings and profits were at least as great. Revenue Act of 1928, §115(a) & (b), 45 Stat. at 822. Neither the Second Circuit nor the Supreme Court addressed this issue. The Commissioner asserted in his brief to the Supreme Court that, in the absence of taxpayer proof to the contrary, Gregory must be treated as if United did have sufficient earnings and profits to make the entire amount a dividend. Brief for Respondent at 8, 26, Gregory v. Helvering, 293 U.S. 465 (1935), available at 1934 WL 60141. That Gregory did not argue in the alternative that United had insufficient earnings and profits to make a deemed distribution a dividend suggests strongly that United had sufficient earnings and profits. See Brief for Petitioner, Gregory v. Helvering, 293 U.S. 465 (1935), available at 1934 WL 60333. This Article accepts that premise of sufficient earnings and profits for the balance of its analysis.

also should have been taxed on the excess of the Monitor stock's value over its basis.³⁷ Hand makes a point of contradicting the Commissioner's view that Averill should be treated as if it never existed. It did exist and there was an exchange of assets between it and United. He then proceeds to acknowledge that the dividend taxation of Gregory would be the same regardless of whether she were treated as having received a dividend of Averill stock or a dividend of Monitor stock. Why then does he bother with the point that there was a transfer between United and Averill? It seems likely that it serves to establish that in principle United should also have been taxable on this transaction based on the exchange that he did not consider a valid reorganization,³⁸ because it did not satisfy the independent business purpose requirement that he had created.

III. HAND'S ASSERTED JUSTIFICATION

In asserting that the business purpose requirement completes the "melody" of the statute, Hand presents three distinct justifications, and they deserve examination. The most directly textual justification he presents is his assertion that "the act itself gives evidence that, on occasion anyway, the purpose of a transaction should be the guide."³⁹ His evidence of this is two provisions of the Revenue Act. One is a provision that a stock redemption be treated as a dividend distribution to the extent that it is "essentially equivalent to the distribution of a taxable dividend."⁴⁰ The other is a provision providing that a distribution of boot property in a reorganization be treated as a dividend to the extent that it "has the effect of the distribution of a taxable dividend."⁴¹

Neither of these provisions refers to purpose as a guide, but Hand is himself, apparently, concluding that "essentially equivalent" and "effect" imply a purpose-oriented test. Supreme Court decisions, decided many years after Hand's opinion in *Gregory*, conclude that a transaction's purpose has no bearing on the application of the same language in the contemporary analogues of those provisions.⁴²

37. *Helvering v. Gregory*, 69 F.2d 809, 810 (2d Cir. 1934).

38. *Helvering*, 69 F.2d at 811.

39. *Id.*

40. Revenue Act of 1928, § 115(g), 45 Stat. at 822-23. See I.R.C. § 302 (2012) (analogous provision in contemporary law).

41. Revenue Act of 1928, § 112(c)(2), 45 Stat. at 817. See I.R.C. § 356(a)(2) (2012) (analogous provision in contemporary law).

42. *United States v. Davis*, 397 U.S. 301, 307-14 (1970) (holding that business purpose has no bearing on whether a stock redemption is essentially equivalent to a dividend); *Comm'r v. Clark*,

Regardless of the weakness of Hand's assertion that these are purpose-oriented provisions, there is a greater problem of what purpose orientation in these provisions would imply for the reorganization definition. It is possible that Hand's point is that the interpretive imputation of a purpose requirement in those provisions proves that the court has the authority to impute a purpose requirement in another provision, but how are the occasions of such cross imputation to be identified and justified? He does not say.

Second, Hand cites the cases creating a continuity of proprietary interest requirement in the context of acquisitive reorganizations,⁴³ even though there is no express reference to it in the statutory language.⁴⁴ Hand refers to these cases as "pertinent, if not authoritative," and goes on to assert that, "The violence done the literal interpretation of the words is no less than what we do here."⁴⁵ Without rehearsing the appropriateness of the judicial imputation of the continuity of interest requirement to the acquisitive reorganization provision, it seems that the most Hand can, or wants to, get from these decisions is that the authority for the judicial imputation of an unstated requirement in one provision justifies the assertion of that authority to impute another different unstated requirement in a related provision. Neither of those cases can explain whether, or why, a purpose requirement should be imputed to the reorganization provision.⁴⁶

Third, Hand justifies his assertion of a business purpose requirement by quoting from legislative history⁴⁷ that the purpose of the

489 U.S. 726, 737-40 (1989) (interpreting "effect of the distribution of a dividend" without reference to the purpose of the transaction under consideration).

43. *Pinellas Ice & Cold Storage Co. v. Comm'r*, 287 U.S. 462 (1933); *Prairie Oil & Gas Co. v. Motter*, 66 F.2d 309, 311 (10th Cir. 1933); *Cortland Specialty Co. v. Comm'r*, 60 F.2d 937 (2d Cir. 1932).

44. Revenue Act of 1928, § 112(i)(1)(A), 45 Stat. at 818; Revenue Act of 1926, Ch. 27, § 203(h)(1)(A), 44 Stat. 9, 14; Revenue Act of 1924, Ch. 234, § 203(h)(1)(A), 43 Stat. 253, 257. *See* I.R.C. § 368(a)(1)(A), (B), & (C) (2012) (analogous provisions in contemporary law).

45. *Helvering v. Gregory*, 69 F.2d 809, 811 (2d Cir. 1934).

46. Hand also cites *Lonsdale v. Comm'r*, 32 F.2d 537, 539 (8th Cir. 1929), a case in which a corporation declared a cash dividend to its shareholders and gave them the option to invest the dividend in a new corporation. The transaction failed to meet the literal definition of the alleged spin-off reorganization, which required a direct transfer from one corporation to another. *See* Revenue Act of 1924, Ch. 234, § 203(h)(1)(B), 43 Stat. 253, 257.

47. The appropriateness of consulting legislative history in the interpretation of statutes is a question that has been hotly contested in recent decades, *see, e.g.*, ANTONIN SCALIA, *A MATTER OF INTERPRETATION: FEDERAL COURTS AND THE LAW* 29-37 (1997) (rejecting the use of legislative history); CHRISTIAN W. MAMMEN, *USING LEGISLATIVE HISTORY IN AMERICAN STATUTORY INTERPRETATION* 153-86 (2002) (reviewing arguments in favor of and opposed to the use of legislative history), but that debate is not directly addressed by this Article.

reorganization provision is to exempt “from tax the gain from exchanges made in connection with a reorganization in order that ordinary business transactions will not be prevented.”⁴⁸ Yet it far from obvious that Gregory’s transaction is not an ordinary business transaction. One might easily take the view that the transaction was an ordinary one of removing assets from a corporation that satisfied all of the explicit requirements of the statute in order to prevent the payment of more tax than strictly mandated by the law.

Hand, however, makes a leap that the set of “ordinary business transactions” to which the Congressional committee reports referred was more restrictive than actually described by the statute, and then he makes a further leap that it is necessary to impose an unstated requirement that only transactions satisfying his business purpose requirement are “ordinary.” At the same time, he makes no reference to other portions of those same committee reports that indicate that the reorganization provision was drafted in a manner that “results in definiteness and accuracy and enables a taxpayer to determine prior to the consummation of a given transaction the tax liability that will result therefrom.”⁴⁹ Neither the business purpose requirement by itself nor raising the prospect of qualifications unstated in the statutory text serve those ends. Implicitly, Hand made another leap, that limiting reorganization treatment to those satisfying his concept of “ordinary business transactions” was important enough to disregard the expressed desire for increased definiteness of taxpayers’ ability to determine the tax treatment of their transactions *ex ante*. At no point does he explain why “ordinary” implies the unlegislated business purpose requirement.

In fact, none of Hand’s asserted justifications directly support an inference that, as an interpretive matter, the correct unlegislated piece of the statute is a business purpose requirement. It is unlikely that Hand even saw the problem in those terms. It is more likely that he asserted these justifications as giving him authority to impute a requirement not stated in the statutory language but that he concluded to be necessary. That position, however, can be justified only if one accepts a number of assumptions: that there is a single clear normative principle of taxation underlying the statute; that Hand has correctly identified that normative

48. H.R. REP. NO. 68-179 (1924), S. Rep. No. 68-398 (1924), *reprinted in* JACOB S. SEIDMAN, SEIDMAN’S, LEGISLATIVE HISTORY OF FEDERAL INCOME TAX LAWS: 1938-1861 690 (1938).

49. H.R. REP. NO. 68-179 (1924), S. Rep. No. 68-398 (1924), *reprinted in* JACOB S. SEIDMAN, SEIDMAN’S LEGISLATIVE HISTORY OF FEDERAL INCOME TAX LAWS: 1938-1861 687 (1938).

principle; that all provisions in the statute contrary to that principle are deviations from the norm to be interpreted narrowly; and that it is a court's function to police for gaps in the statute that allow for "excessive" deviations from the normative principle and to devise mechanisms to fill those gaps.

That foundation of those assumptions, however, breaks down right at the beginning if the taxing statute does not represent a single normative principle of taxation. If instead the tax law is and always has been an elaborate compromise between directly competing visions of ideal tax policy, without a single normative baseline, it simply is not possible to sort taxing provisions into normative provisions and exception provisions. In that case, no neutral principle identifies gaps to be filled. The question then is to identify these additional normative principles reflected in the statute. The analysis turns next to several perspectives that serve as normative principles of taxation; perspectives from which Hand's analysis is wrong as to Evelyn Gregory's transactions.

IV. AN INTEGRATIONIST PERSPECTIVE

From an Integrationist Perspective double taxation is problematic because of the distortions to allocative efficiency and distributive equity that it generates.⁵⁰ Integrationism would exactly eliminate the excess burden of double taxation and the economic and distributive distortions that double taxation entails. In principle, the nearest one might come to a perfectly integrated regime is the fiscal transparency of a full passthrough regime. Under such a tax regime, there would be no corporate-level tax. Instead, all of the revenue of the corporation would be taxed as income of some individual. The nearest analogue is the tax treatment of partnerships.⁵¹

The Integrationist Perspective counsels that the Gregory transactions should generate a single level of tax, not two. That tax should be at the shareholder level, because business entities should be fiscally transparent. Further, the disposition of corporate assets should be treated as nearly as possible as if the shareholders owned those assets

50. See Polito, *supra* note 5.

51. See I.R.C. §§ 701-777, 6221-6234 (2012). In practice, fiscal transparency cannot be effected in a manner that fully eliminates all distinctions between a business conducted directly as an individual's sole proprietorship and an enterprise conducted through a legal structure. See LAURA E. CUNNINGHAM & NOEL B. CUNNINGHAM, *THE LOGIC OF SUBCHAPTER K* (3d ed. 2006). Nevertheless, the partnership paradigm appears to be the nearest alternative possible to the integrationist ideal.

directly without the intervention of a juridical business entity.⁵² Therefore, because the disposition of the Monitor stock would qualify for capital gain treatment⁵³ if it had been held as part of an investment portfolio in an individual taxpayer's hands,⁵⁴ the Integrationist Perspective counsels that it should be treated as a capital asset notwithstanding that it was held in an investment company⁵⁵ in the form of a corporation.

Thus, from the Integrationist Perspective, Gregory's treatment of this transaction, as modified by the Board of Tax Appeals,⁵⁶ is the correct result. As a consequence of the reorganization and liquidation, there was no corporate level tax. Gregory reported a gain and paid a tax at capital gain rates to the same extent as if she had held the assets directly.⁵⁷ Hand's disallowance of reorganization treatment by creating a business purpose requirement would, if his preferred structure were executed in full, have had the result only of reinforcing the distortions of the double tax system.⁵⁸ Gregory's transactions, if respected at face value, would have had the virtue of correcting those distortions in this case.

52. Cf. I.R.C. § 702 (2012).

53. See Revenue Act of 1928, § 101(a), 45 Stat. at 811.

54. Under the Revenue Act of 1928, the term "capital asset" referred to:

[P]roperty held by the taxpayer for more than two years (whether or not connected with his trade or business) but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale in the course of his trade or business.

Revenue Act of 1928, § 101(c)(8), 45 Stat. at 811-12. The Revenue Act of 1928 provided no other carve-outs from capital asset classification for assets that met the minimum holding period requirement. Because the disposition of stock held by an investor does not fall within the above exclusion from capital asset treatment, the Monitor stock was properly classified as a capital asset under that provision, to the extent it met the requisite two year holding period. See, e.g., *Taylor v. Comm'r*, 76 F.2d 904 (2d Cir. 1935); *Wallace v. U.S.*, 50 F. Supp. 178 (D.C. N.Y. 1943); *Trost v. Comm'r*, 34 B.T.A. 24 (1936); *Weld v. Comm'r*, 31 B.T.A. 600 (1934); *Gilbert v. Comm'r*, 20 B.T.A. 765 (1930). In 1934, this statutory language was amended to refer to "property held by the taxpayer primarily for sale to customers . . ." Revenue Act of 1934, ch. 277, § 117(b), 48 Stat. 680, 714 (emphasis added). The amendment was justified as "making it impossible to contend that a stock speculator trading on his own account is not subject to . . . [capital gain treatment.]" H.R. REP. NO. 73-1385, at 22 (1934).

55. United was an investment company, see Brief for Petitioner at 3, *Gregory v. Helvering*, 293 U.S. 465 (1935), available at 1934 WL 60333.

56. *Gregory v. Comm'r*, 27 B.T.A. at 226.

57. See *supra* notes 21-31 and accompanying text.

58. *Helvering v. Gregory*, 69 F.2d 809, 810 (2d Cir. 1934).

A. The Basis Question

There remains, within the Integrationist Perspective, a potential technical objection that the amount of gain Gregory reported was too low because of the manner in which basis was allocated between her United stock and the Averill stock. Gregory apportioned her original basis in the United stock to the Averill stock in proportion to its value relative to the remaining value of the United stock.⁵⁹ Thus, immediately after the spin-off, her basis in the Averill stock was \$57,325.45, and her remaining basis in the United stock was \$292,674.55.⁶⁰ Gregory reported gain upon the liquidation of Averill in the amount of \$76,007.88, calculated as \$133,333.33 (the fair market value of the Monitor stock)⁶¹ less \$57,325.45 (the apportioned basis in her Averill stock).⁶²

The potential technical objection is that the basis used in the gain calculation was too high and the appropriate basis was \$10,413.07, the price at which United purchased the Monitor stock.⁶³ If the lower basis were used, Gregory would have reported an additional gain of \$46,912.38 in 1928. Her basis in the United stock would be correspondingly increased by the same amount and a later disposition of that stock would have resulted in a correspondingly lower gain. In that sense, the objection pertains to a deferral of taxation with respect to \$46,912.38.

A useful exercise is to determine an *upper* limit to the value of the deferral involved. If one assumes that Gregory would have inherited United's basis in the Monitor stock, it seems fair to imagine she would also have inherited its holding period,⁶⁴ which began in 1922.⁶⁵ Therefore, the gain would all have been capital gain subject to a

59. Revenue Act of 1928, § 113(a)(9), 45 Stat. at 820.

60. Gregory v. Comm'r, 27 B.T.A. at 224; Brief for Petitioner at 4, Gregory v. Helvering, 293 U.S. 465 (1935), available at 1934 WL 60333.

61. The value of the Monitor stock was determined based on its sale price on the same day. Gregory v. Comm'r, 27 B.T.A. at 224.

62. *Id.* See also Revenue Act of 1928, §§ 111(a), 115(c), 45 Stat. at 815, 822.

63. Brief for Respondent at 3, Gregory v. Helvering, 293 U.S. 465 (1935), available at 1934 WL 60141.

64. *Cf.* I.R.C. § 1223(2) (2012). If that were true, the \$76,007.88 gain that Gregory did report would all have been capital gain, rather than only 66 percent capital gain, see *supra* note 31 and accompanying text. In that case, her tax on the reported gain would have been lower than what she actually paid. That amount should, in principle, be offset against and reduce the amount of deferred tax in comparison to the actual treatment of the transactions. However, that offset is superfluous to the point made here and the estimation of that reduction is not pursued.

65. Brief for Respondent at 3, Gregory v. Helvering, 293 U.S. 465 (1935), available at 1934 WL 60141.

maximum tax rate of 12.5 percent.⁶⁶ That makes the deferred tax \$5,864.05 (12.5 percent of \$46,912.38). If Gregory continued to hold the United stock through the time of her death, that deferral would have been permanent because of the step-up in basis for property transmitted at death.⁶⁷ Based on that assumption, the amount of the tax is also the *upper* limit on the value of the deferral.⁶⁸

An important counterpoint to this deferral question arises from noting that United was treated by both Gregory and the IRS as having earnings and profits at least as great as the value of the Monitor stock.⁶⁹ Because a single shareholder-level tax is normative from the Integrationist Perspective, the corporate level tax paid in relation to those earnings should in principle be credited against the normative shareholder level tax. Therefore, even if the gain on the disposition of the Monitor stock should have been determined in 1928 using the lower basis figure, the value of deferral at the shareholder level should be

66. Revenue Act of 1928, § 101, 45 Stat. at 811-12.

67. Revenue Act of 1928, § 113(a)(5), 45 Stat. at 819.

68. An interesting perspective is to compare, in the particular circumstances of the *Gregory* case, the upper limit to the value of the deferral with the extent of the excess tax burden, from an Integrationist Perspective, of imposing the double tax treatment that Hand assumed to be the norm. At the outset, it is important to note that it is difficult, if it is possible at all, to compare the welfare harm to society of a dollar of deferral to the welfare harm of a dollar of excess tax burden from double taxation. This is because there is no *a priori* reason to assume that a dollar of each produces social welfare harm in the same amount. Therefore, this comparison of numbers is not dispositive, but it does shed some light on the question.

Starting with the upper limit to deferral already calculated, the next step is to estimate the excess tax burden of imposing full double taxation. Caution counsels calculating a *lower* limit on the excess tax burden. Based on the corporate tax rate of 12 percent, Revenue Act of 1928, § 13, 45 Stat. at 797, if United had sold the Monitor shares, its marginal tax would have been \$14,750.43 (12 percent x (\$133,333.33 - \$10,413.07)). Assume a dividend distribution to Gregory of the full value of the Monitor shares, but take the lowest estimate of the dividend tax by assuming the dividend was her only net income for the taxable year. Revenue Act of 1928, § 12, 45 Stat. at 796-97. This produces a dividend tax of \$18,326.67. The sum of these two figures is then reduced by the maximum estimate of a single shareholder level tax at capital gain rates. Using the same basis figure as used in determining the deferral and assuming the application of the maximum capital gain rate, Revenue Act of 1928, § 101, 45 Stat. at 811-12, the shareholder level tax would have been \$15,365.03 (12.5 percent x (\$133,333.33 - \$10,413.07)). That produces a *lower* limit on the excess tax burden of \$17,712.07 (\$14,750.43 + \$18,326.67 - \$15,365.03). Note that based on the assumption that proceeds of the Monitor stock sale were Gregory's only income, to *minimize the dividend tax* and then to use of the *maximum capital gain rate* actually *overstates* the effective normative single shareholder tax. Revenue Act of 1928, §§ 12, 101, 45 Stat. at 796-97, 811-12. That further *understates the extent of the excess tax burden*. At an *absolute minimum*, the excess tax burden of imposing full double taxation in the *Gregory* situation is more than 300 percent (\$17,712.07/\$5,864.05) of the value of the deferral of using the higher basis number. As noted above, this comparison does not dispositively prove the relative welfare loss to society of deferral in comparison to the excess burden of double taxation, but it is worth noting.

69. See *supra* note 36.

correspondingly offset by the corporate level tax with respect to the distribution of earnings previously taxed at the corporate level.

In practice, it is impossible to determine the exact amount of corporate tax that should be seen as offsetting the normative shareholder level tax, because the disparity between corporate tax rates and individual rates varied substantially over the years during which United's earnings were accumulated.⁷⁰ Nevertheless, an estimate is possible based on the 1928 rates. At that time, the corporate tax rate of 12 percent⁷¹ was seven percentage points higher than the maximum individual normal tax rate⁷² for which it substituted.⁷³ Using those figures, one can estimate that the amount of corporate tax that should offset the deferral is \$10,606.0 ($\$133,333.33 \times (.07/(1 - 0.12))$). Based on those figures, in Gregory's case, the excess tax at the corporate level more than fully offsets and pays for the tax deferral estimated above. The actual offset may well have been smaller because the disparity between the corporate tax rate and the maximum individual normal rate for which it substitutes may have been smaller in the years earnings were accumulated. Nevertheless, it is fair to say that even if one concludes that using the higher basis figure was a mistake, the consequent deferral is at least partially offset, from an Integrationist Perspective, by the excess corporate tax.

These estimates, depending so heavily upon the specific circumstances of the *Gregory* transactions, are difficult to generalize. Perhaps the best, and most straightforward, way to consider this question is to address the problem of basis allocation directly. It is true that the allocation of basis between the Averill stock and the Monitor stock did control the degree to which gain taxation could be deferred. That kind of basis allocation question, which is unavoidable within the context of a transactionalist⁷⁴ tax system, is necessarily arbitrary,⁷⁵ and this is perhaps never more so than when a single investment is divided into

70. STEVEN A. BANK, *FROM SWORD TO SHIELD: THE TRANSFORMATION OF THE CORPORATE INCOME TAX, 1861 TO PRESENT* 109 (2010).

71. Revenue Act of 1928, § 13, 45 Stat. at 797.

72. Revenue Act of 1928, § 11, 45 Stat. at 795.

73. See *infra* notes 88-114 and accompanying text.

74. A transactionalist tax system refers to a system, like the Internal Revenue Code, that measures the tax base by reference solely to completed transactions. It is in contrast to an accretionist system in which changes to asset value are taken into account in the years in which they accrue in an economic sense without waiting for a completed transaction to measure that accretion.

75. See Anthony P. Polito, *Borrowing, Return of Capital Conventions and the Structure of the Income Tax: An Essay in Statutory Interpretation*, 17 VA. TAX REV. 467 (1998).

two⁷⁶ as occurred in *Gregory*. One model would have been the treatment that applies currently when a partnership distributes an asset to a partner without triggering gain recognition. The partner's basis in the distributed asset is the same as the partnership's basis in the asset,⁷⁷ and the partner's basis in the partnership interest is reduced *pro tanto*.⁷⁸ That model would have produced the higher 1928 gain indicated above. In the context of a reorganization, Congress elected to apportion basis in proportion to value, producing the lower 1928 gain figure.⁷⁹

There is no *a priori* principle that would justify preferring one basis allocation over the other. It is necessarily a policy question as to how much untaxed gain should be preserved in each asset.⁸⁰ This is a policy question that is quite distinct from that of whether to prefer an integrated tax system or a double tax system. In that sense, the Integrationist Perspective would counsel setting the issue aside and accepting the result of the literal application of the basis convention that Congress prescribed for the transaction in question. In that sense, there is no deferral, or at least there is no deferral that would have called for a judicial remedy. The basis question is a policy question independent of the tax integration question and one best left to Congress.

B. "But, It's a Double Tax System, Isn't It?"

Having addressed the basis question, the analysis is left with the conclusion that respecting the treatment of *Gregory*'s transactions would have produced the correct result from an Integrationist Perspective. Hand's introduction of a business purpose requirement into a statute that did not provide for one was counterproductive to the extent that it succeeded in undermining the integrationist result. Yet, one must anticipate an objection that the Integrationist Perspective is not the statutory norm and that Hand was correct when he characterized double taxation as the norm. The objection is that, "It's a double tax system, not an integrated system."

In fact, such a claim was a bad exaggeration in 1928 and remains so today. The system is actually a complicated compromise between the Integrationist Perspective and double taxation. Clearly there were, and are, substantial elements of corporate double taxation to U.S. tax law.

76. *Id.* at 542-43, 548-51.

77. I.R.C. § 732(a) (2012).

78. I.R.C. § 733 (2012).

79. Revenue Act of 1928, § 113(a)(9), 45 Stat. at 820.

80. See *Polito*, *supra* note 75, at 556-71.

At the same time, however, there have always been significant elements of the tax law that are more consistent with the Integrationist Perspective than with double taxation.

In a pure double-tax system, the imposition of a corporate tax would be irrelevant to the taxation of the investors in a corporate enterprise. Their separate shares of corporate earnings would be subject to a second full individual income tax, perhaps in the same year as earned in the corporation or at the time of distribution. Even the latter possibility could be seen as a deviation from pure double taxation, because the investors'⁸¹ tax would be deferred in comparison to the taxation of investors in fiscally transparent entities. In comparison, pure integrationism would impose no entity level tax at all and would impose a single tax at the investor level in the same year as earned.⁸²

The federal tax treatment of corporations is actually at some intermediate point on the spectrum between those two possibilities, and, at the time of Hand's opinion in *Gregory*, this had been true for many years. The first federal income tax system enacted during the Civil War generally treated corporations as passthrough entities just like partnerships.⁸³ In addition, there was a 5 percent tax on dividends of banking, insurance, and transportation businesses and on interest on bonded indebtedness of transportation businesses.⁸⁴ However, dividends and interest were deductible by individual taxpayers if already taxed at the corporate level.⁸⁵ The individual income tax did not apply to incomes below \$600 and was applied at graduated rates of up to 10

81. Even the use of the term "investor" here, instead of shareholder, member, owner, etc., is intentional to emphasize that even the distinction in treatment between debt and equity could be considered a deviation from pure double taxation. Interest payments on corporate debt have always been deductible by the corporation. See Revenue Act of 1928, § 23(b), 45 Stat. at 799; I.R.C. § 163 (2012). In effect, the deduction equates the taxable corporation with the share of its revenue stream that accrues to the benefit of its shareholders. See Alvin C. Warren, Jr., *The Corporate Interest Deduction: A Policy Evaluation*, 83 YALE L.J. 1585, 1587-88 (1974). A policy perspective could be used to justify imposing double taxation to a broader or narrower base, but the distinction between debt and equity is the arbitrary line under the statute that defines the extent of that imposition. See Anthony P. Polito, *Useful Fictions: Debt and Equity Classification in Corporate Tax Law*, 30 ARIZ. ST. L.J. 761 (1998).

82. See, e.g., I.R.C. § 701 (2012).

83. Act of June 30, 1864, ch.173, § 117, 13 Stat. 223, 282.

84. Act of June 30, 1864, §§ 120-122, 13 Stat. at 283-85. These taxes were not imposed on corporations per se, but based on the nature of the business conducted. Nevertheless, most of these businesses were conducted in corporate form. See Bank, *supra*, note 70, at 15. There was a 5 percent tax on undistributed earnings of banking and insurance businesses, but that tax was credited against the tax on dividends when those earnings were later distributed. Act of June 30, 1864, § 121, 13 Stat. at 284.

85. Act of June 30, 1864, § 117, 13 Stat. at 282.

percent.⁸⁶ This created a degree of double taxation to the extent dividends and interest were fully taxable at the corporate level with respect to shareholders below the \$600 threshold, but it also created preferential treatment for shareholders who were themselves taxable at the higher rates.⁸⁷ The tax then was primarily an integrated tax.

The 1894 tax act would have imposed⁸⁸ a separate corporate tax but also achieved a form of tax integration. A 2 percent tax was imposed on the income of individuals and corporations alike, but dividends were not subject to the individual income tax. Thus, the corporate tax served as a surrogate for the taxation of individual shareholders on their shares of corporate earnings. The integration achieved, however, was not perfect. Individuals were subject to separate taxation only to the extent that their incomes exceeded a threshold amount of \$4,000.⁸⁹ The threshold amount did not apply to corporations, and the full 2 percent tax applied to corporate earnings regardless of whether individual shareholders' incomes were less than the threshold.⁹⁰ That disparity effectively imposed a limited extent of double taxation, but it was primarily an integrated tax.

The first income tax enacted under the authority of the Sixteenth Amendment,⁹¹ also achieved a form of tax integration. The individual income tax was split into two components: a normal tax of 1 percent of incomes in excess of an exemption amount of \$3,000 for single filers and \$4,000 for married filers; and a surtax ranging from 1 percent to 6 percent on incomes in excess of \$20,000.⁹² The surtax added a degree of progressivity to the individual income tax. Corporations were subject to a flat 1 percent tax,⁹³ but dividends were subject only to the surtax in shareholders' hands.⁹⁴ Thus, as in the case of 1894 tax, the corporate tax substituted for the individual shareholder tax, achieving a rough form of rate integration.

It was, however, not perfect integrationism. First, there was the

86. Act of June 30, 1864, § 116, 13 Stat. at 281.

87. In addition, there was a gross receipts tax on certain types of business conducted primarily in corporate form. Act of July 1, 1862, ch. 119, § 80, 12 Stat. 432, 468-69 (3 percent gross receipts tax); Act of June 30, 1864, § 103, 13 Stat. at 275-76 (2.5 percent gross receipts tax).

88. The Supreme Court ruled the tax act unconstitutional before it could take effect. *Pollock v. Farmers' Loan & Trust Co.*, 158 U.S. 601 (1895).

89. Act of August 27, 1894, ch. 349, §§ 27-28 & 32, 28 Stat. 509, 553-54, 556.

90. See *BANK*, *supra* note 70, at 51-52.

91. U.S. Const. amend. XVI.

92. Revenue Act of 1913, ch. 16, § 2(A), 38 Stat. 114, 166-67.

93. Revenue Act of 1913, § 2(G), 38 Stat. at 172.

94. Revenue Act of 1913, § 2(B), 38 Stat. at 167.

inapplicability of the exemption amounts to earnings in corporate form, which imposed double taxation to a partial degree. At the same time, the application of the surtax on corporate earnings was deferred until distribution. In present value terms, therefore, the tax imposed on corporate earnings was less for a corporation retaining earnings than for a partnership subject to immediate passthrough treatment. As an offset to this possibility, individuals were subject to the full surtax on their shares of retained gains and profits of corporations “formed or fraudulently availed of for the purpose of preventing the imposition of such tax through the [retention of earnings] . . . [and of which] . . . the gains and profits are permitted to accumulate beyond the reasonable needs of the business shall be prima facie evidence of a fraudulent purpose”⁹⁵ In practice, it was possible to accumulate significant earnings without triggering this additional tax. Overall, the Revenue Act of 1913 is well described as an integrated income tax.

The War Revenue Act of 1917, however, raised the maximum surtax to 50 percent.⁹⁶ Therefore, continuing to tax corporations at a rate equal to the normal individual rate and taxing distributions at only the surtax rate created a substantial preference, in present value terms, for retained corporate earnings in comparison to earnings retained in a partnership subject to passthrough treatment. In fact, if—as was widely supposed—the surtax rates were to be reduced substantially after World War I, the ability to retain corporate earnings would have turned into a significant partial exemption from the surtax, in comparison to earnings via a partnership subject to passthrough taxation.

A proposed resolution considered by Congress was to impose a 15 percent tax on retained corporate earnings in excess of an exemption amount of 20 percent of corporate earnings. The full surtax would have continued to apply to distributed corporate earnings. Instead of moving in this direction toward double taxation, Congress adopted a compromise position. Congress raised the corporate tax by two percentage points above the normal individual tax.⁹⁷ Thus, distributed corporate earnings were subject to a higher combined corporate and individual rate than other forms of income subject only to individual taxation, but the extent of double taxation of distributed earnings was relatively minor.⁹⁸ Congress also imposed a 10 percent tax on corporate earnings retained

95. Revenue Act of 1913, § 2(A), 38 Stat. at 166-67.

96. War Revenue Act of 1917, ch. 63, § 2, 40 Stat. 300, 301

97. War Revenue Act of 1917, §§ 1, 4, 40 Stat. at 300-01, 302.

98. BANK, *supra*, note 70, at 94-96.

beyond the reasonable requirements of the business,⁹⁹ which imposed a second level of tax on some but not all corporations and—even when imposed—was at a significantly lower rate than the maximum individual surtax.¹⁰⁰

The Revenue Act of 1918 set the corporate tax rate for that year at 12 percent, the same as the maximum normal tax rate for individuals. With dividends still subject to only the surtax, it reintroduced the tax rate integration of prior years. For 1919 and 1920, Congress reduced the maximum corporate tax rate to 10 percent and reduced the maximum normal tax rate for individuals to 8 percent, thereby introducing a limited degree of double taxation on distributed earnings to the extent of that two point spread.¹⁰¹ The introduction of a lower normal rate bracket for lower income, 6 percent in 1918, and 4 percent in 1919 and 1920, without a mechanism for applying it to corporations, further introduced a limited degree of double taxation.¹⁰² At the same time, that the corporate tax was all or mostly offset by not applying the normal tax to dividends resulted in a significant degree to tax integration.

This form of partial tax integration, via the practice of imposing a corporate tax at a rate higher than the maximum normal individual rate, and subjecting dividends only to the individual surtax but not the normal tax, continued through 1935.¹⁰³ The Revenue Act of 1928, the law applicable to Gregory's transactions, set a corporate tax rate of 12 percent,¹⁰⁴ seven percentage points higher than the maximum normal individual rate of 5 percent.¹⁰⁵ The normal rate also included two lower brackets, 1.5 percent for the first \$4,000 of income, and 3 percent for the second \$4,000.¹⁰⁶ As in the case of prior acts, the normal tax did not

99. War Revenue Act of 1917, § 1206(2), 40 Stat. at 334.

100. The War Revenue Act of 1917 also imposed a war excess profits tax on every business whether conducted as a corporation, partnership, or individual proprietorship. War Revenue Act of 1917, § 201, 40 Stat. at 303.

101. Revenue Act of 1918, ch. 18, §§ 210, 216, 230, 40 Stat. 1057, 1062, 1069, 1075-76.

102. Revenue Act of 1918, §210, 40 Stat. at 1062. The 1918 Act introduced a further degree of double taxation by limiting the application of the war excess profits tax, see *supra* note 100, only to corporations. Revenue Act of 1918, §301, 40 Stat. at 1088. The World War I war profits tax was last applied in 1921. Revenue Act of 1921, ch. 136, §301, 42 Stat. 227, 272.

103. See BANK, *supra* note 70, at 109. The Revenue Act of 1936 subjected dividends to both the normal tax and the surtax for the first time. Prior acts had provided for the deduction of dividends for determining net income subject to the individual normal tax. Compare Revenue Act of 1934, ch. 277, § 25(a)(1), 48 Stat. 680, 692 with Revenue Act of 1936, ch.690, § 25, 49 Stat. 1648, 1662-63.

104. Revenue Act of 1928, § 13, 45 Stat. at 797.

105. Revenue Act of 1928, § 11, 45 Stat. at 795.

106. *Id.*

apply to dividends.¹⁰⁷ The surtax on individuals, which did apply to dividends, ranged from 1 percent to 20 percent.¹⁰⁸ Thus, the maximum rate on most individual income was 25 percent, but the sum of maximum rates on distributed corporate earnings was 32 percent (12 percent corporate tax rate plus 20 percent surtax).

In an important sense, the taxation of corporate distributions resembles that in effect as of this writing. The maximum corporate tax rate is 35 percent,¹⁰⁹ and individual income tax rates are as high as 39.6 percent.¹¹⁰ The maximum individual tax rate on qualified dividends,¹¹¹ however, was no more than 15 percent from 2003 through 2012¹¹² and is no more than 20 percent beginning in 2013.¹¹³ In both 1928, and today, the maximum combined tax rate on corporate earnings is more than the ordinary rate on other individual income, but the individual dividend rate is partly reduced to reflect that dividend distributions have already been taxed at the corporate level. Either in 1928 or in 2014, one might call this partial double taxation or partial tax integration. Either way, it is a compromise position between pure double taxation and full tax integration.¹¹⁴

Within the context of that compromise tax system there were, and are, legislatively approved mechanisms that allow taxpayers to bypass double taxation. This analysis focuses on those available in 1928.

107. Revenue Act of 1928, § 25, 45 Stat. at 802-03.

108. Revenue Act of 1928, § 12, 45 Stat. at 796-97.

109. I.R.C. § 11(b) (2012).

110. Beginning in 2013, a marginal tax rate of 39.6 percent applies to taxable income above a threshold of \$400,000 for single individuals, \$425,000 for heads of household, and \$450,000 for married couples. For all other taxpayers, the individual tax rates remain as they had been before, at various rates up to 35 percent. I.R.C. § 1(i) (2012), as amended by American Taxpayer Relief Act of 2012, Pub. L. No. 112-240, § 101, 126 Stat. 2313, 2315-16.

111. I.R.C. § 1(h)(11) (2012).

112. Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, §§ 302-303, 117 Stat. 752, 760-64 (2003) (adopting reduced rate dividend taxation for taxable years beginning through 2008); Tax Increase Prevention and Reconciliation Act of 2005, Pub. L. No. 109-222, § 102, 120 Stat. 345, 346 (2006) (extending reduced rate dividend taxation through taxable years beginning in 2010); Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, § 102, 124 Stat. 3296, 3298-99 (2010) (extending reduced rate dividend taxation through taxable years beginning in 2012).

113. American Taxpayer Relief Act of 2012, Pub. L. No. 112-240, § 102, 126 Stat. 2313, 2318 (2012) (increasing the maximum income tax rate on qualified dividends to 20 percent).

114. See H.R. REP. NO. 108-94, at 27-8 (2003); See also Rosanne Altshuler, Benjamin H. Harris, & Eric Toder, *Capital Income Taxation and Progressivity in a Global Economy*, 30 VA. TAX REV. 355, 357-58 (2010); Steven A. Bank, *The Rise and Fall of Post-World War II Tax Reform*, 73 LAW & CONTEMP. PROBS. 207, 207 (2010); Michael Doran, *Managers, Shareholders, and the Corporate Double Tax*, 95 VA. L. REV. 517, 525-26 (2009); Steven A. Bank, *Dividends and a Tax Policy in the Long Run*, 2007 U. ILL. L. REV. 533, 537-40 (2007).

Businesses could organize as partnerships¹¹⁵ to qualify for passthrough tax treatment, or they could raise capital as debt rather than equity to qualify for the interest deduction¹¹⁶ shield from the corporate level tax. Under the Revenue Act of 1928, these strategies were effective only in relation to investors in a sufficiently low surtax bracket that it did not justify a strategy of paying the corporate tax and causing the corporation to retain earnings to defer the individual income tax. Using one of these mechanisms clearly would not have been advantageous to all taxpayers. However, that was the taxpayers' decision, and the statute certainly allowed the use of these escape hatches to avoid double taxation to the extent doing so would be advantageous.

Another such escape hatch was, and remains, the treatment of stock redemptions. A portion of the redemption price paid to a shareholder reflects the share's claim on corporate earnings and profits. In a double tax regime, that value should be treated as a dividend. Yet in all liquidation redemptions and some non-liquidation redemptions, the Revenue Act of 1928 permitted the redemption to be treated as a sale,¹¹⁷ thereby effectively bailing out earnings and profits as capital gains and treating value distributed as non-taxable return of basis rather than earnings and profits. The same remains true under the existing Internal Revenue Code.¹¹⁸

Under the prevailing law in 1928, the rule of law commonly referred to as the *General Utilities* principle¹¹⁹ was another such escape hatch. A corporation recognized no gain or loss on liquidation.¹²⁰ As the *Gregory* case itself illustrates, this rule allowed a corporation permanently to avoid the corporate level tax on substantial appreciated gain. The application of the *General Utilities* principle to non-liquidating distributions expanded the ability of corporations permanently to avoid the corporate level tax on appreciated assets.

This brings the analysis back to Hand's assumption that the alternative transaction was a corporate sale of the Monitor stock followed by a distribution. A more likely alternative would have been for United to distribute the Monitor stock to Gregory as a dividend.

115. Revenue Act of 1928, §§ 181-189, 45 Stat. at 840-42.

116. Revenue Act of 1928, § 23(b), 45 Stat. at 799.

117. Revenue Act of 1928, § 115(c) & (g), 45 Stat. at 822-23.

118. I.R.C. §§ 302-304, 331 (2012).

119. *Gen. Utilities & Operating Co. v. Helvering*, 296 U.S. 200 (1935).

120. See *Treas. Reg. § 45, art. 547* (1919), reprinted in 134 UNITED STATES REVENUE ACTS 1909-1950, 140 (Bernard D. Reams, Jr. ed., 1979) ("No gain or loss is realized by a corporation from the mere distribution of its assets in kind upon dissolution, however they may have appreciated or depreciated in value since their acquisition.").

United would have reported no gain on the distribution of the appreciated stock under the *General Utilities* principle. Gregory would have had a dividend in the amount of the Monitor shares' value¹²¹ and taken a basis in the shares equal to their fair market value.¹²² On the sale of the Monitor shares for the same fair market value, she therefore would have reported zero gain. Thus, the alternative transaction still would have led to only one level of tax, except that it would have been on the full value of the Monitor shares and at dividend tax rates instead of capital gain rates.

While it is true that the definitive pronouncement of the *General Utilities* principle¹²³ did not come until almost twenty-one months after Hand's opinion in *Gregory*,¹²⁴ the issue was clearly percolating through the system. Corporations were already taking the position that the distribution of appreciated assets triggered no gain recognition, no doubt based on an analogy to the 1919 treasury regulation providing that a corporation recognized no gain or loss on the distribution of its assets in complete liquidation.¹²⁵ The *General Utilities* transaction itself occurred in 1928, the same year as Gregory's transaction. At the time that Hand was writing his opinion in 1934, the Board of Tax Appeals had upheld the *General Utilities* non-recognition position.¹²⁶ In fairness to Hand, the issue of corporate taxability was not before the Second Circuit and would not have been briefed, and perhaps he had not yet run across the tax position that would eventually come to be known as the *General Utilities* principle.

Nevertheless, it is clear how a transaction identical to Gregory's would be treated after the Supreme Court affirmed Hand's opinion. It would have been structured as a distribution of shares, subject to full dividend taxation, but no tax at the corporate level. Hand assumed that double taxation was the norm, but the use of escape hatches to bypass double taxation was also a part of the system. The existing tax system continues to include a significant number of escape hatches from double taxation.¹²⁷

The tax treatment of corporations was and is a carefully balanced compromise between pure double taxation and integrationism. On the

121. Revenue Act of 1928, § 115(a), 45 Stat. at 822.

122. Cf. I.R.C. § 301(d) (2012).

123. *Gen. Utilities & Operating Co. v. Helvering*, 296 U.S. 200 (1935).

124. *Helvering v. Gregory*, 69 F.2d 809 (2d Cir. 1934).

125. See *supra* note 120.

126. *Gen. Utilities & Operating Co. v. Comm'r*, 29 B.T.A. 934 (1934).

127. See Polito, *supra* note 5, at 36-40, 52-57, 65.

spectrum between those two poles, the balancing point of that compromise simply moves as the legislative winds change. Likewise, the system had and continues to have sanctioned escape hatches from double taxation, even though sometimes there are more available and sometimes fewer as one side or another gains the upper hand in the double tax vs. integrationism policy debate. Taking the Revenue Act of 1928 at face value, Gregory simply discovered another escape hatch from double taxation that allowed the integrationist result, and Hand's creation of the business purpose requirement served partially to block that particular escape hatch.

This analysis demonstrates that Hand's view is not aided by an assertion that the norm for the system is double taxation. Congress did not enact double taxation as the overriding norm of the system. It enacted a legislative compromise between double taxation and integrationism, which contained multiple approved escape hatches from double taxation. As a consequence, the judicial creation of a new mechanism to reinforce double taxation was not justified based on the court's own preference for one side of the policy debate that led to the legislative compromise, especially given that the carefully crafted legislative text bore no indication at all of a Congressional command for a business purposes requirement that would close explicit escape hatches.

V. MULTIPLE TAXATION IN A DOUBLE-TAX SYSTEM

Even if one takes double taxation of corporate earnings as normative, there is a particular fact in Gregory's case that contradicts Hand's assumption that the normative result was taxation of both United and Gregory in these transactions. The asset spun-off from United was stock of a taxable corporation. Taxation of Monitor and of Gregory constituted double taxation. Imposition of a further tax on United was a third level of tax. Whatever may be said about double taxation, it is even more difficult to justify yet another level of tax.¹²⁸

In that regard, it is worth noting that the value of the Monitor stock spun-off to Gregory can be divided into three components: (1) invested capital represented by basis; (2) a claim on Monitor's earnings and profits; and (3) the anticipation of future income to Monitor either in the form of earnings or the future realization of asset appreciation already

128. See, e.g., Daniel C. Schaffer, *The Income Tax on Intercorporate Dividends*, 33 TAX LAW. 161 (1979).

accrued. Because “[a]djusted basis reflects . . . the whole history of the tax treatment of an item that is to be closed out on disposition,”¹²⁹ it reflects a taxpayer’s tax-paid and tax-forgiven investment in an asset. By definition, therefore, its recovery is non-taxable.¹³⁰

Second, to the extent that the value of Monitor stock represented a claim on earnings and profits, it had already been subject to corporate taxation and, even within a double tax regime, was not appropriately subject to a second *corporate* level of tax. It is true that some of these amounts might have been functionally subject to a zero corporate tax rate,¹³¹ but still included in earnings and profits.¹³² However, they would have received the same treatment if received directly in United’s hands, and, therefore, a second corporate level of tax was unnecessary. The existence of the intercorporate dividends received deduction¹³³ acknowledges this point and serves to mitigate the problem of multiple taxation.

The remainder of the stock’s value represented a claim on amounts that would be subject to taxation at the Monitor level at a future time. The effectuation of double tax did not require taxing those amounts in United’s hands as well. One might object that not taxing this last component of Monitor stock value on United’s transfer of the shares effectively would have allowed tax deferral to the extent that it represented unrealized appreciation of assets held by Monitor. However, that tax would have been deferred in any case, even if Gregory had held the shares directly. That deferral is the consequence of the realization rule itself and not the corporate holding of the Monitor stock.

Thus, a double tax system had no intrinsic need to impose a tax at the United level. The dividends received deduction¹³⁴ made it possible to move previously taxed earnings up the next level in the corporate chain without triggering a multiple tax problem.¹³⁵ However, a

129. William D. Andrews, *On Beyond Tufts*, 61 TAXES (CCH) 949, 954 (1983).

130. See I.R.C. §§ 301(c)(2), 1001 (2012).

131. Cf. I.R.C. § 103 (2012) (state and local bond interest).

132. Cf. Treas. Reg. § 1.312-6(b) (1960).

133. Revenue Act of 1928, § 23(p), 45 Stat. at 801-02; I.R.C. §§ 243-246A (2012).

134. Revenue Act of 1928, § 23(p), 45 Stat. at 801-02.

135. Until 1935, the deduction was 100 percent of all dividends received in all cases. In that year, the deduction was reduced to 90 percent. Revenue Act of 1935, § 102(h), 49 Stat. 1014, 1016. At the time this change was justified as (1) offsetting the benefit of dividing a single business into multiple corporations and thereby getting multiple uses of the lower tax brackets, and (2) a means for discouraging holding company structures that were thought problematic at the time. See Schaffer, *supra* note 128, at 163-69. In general, the current structure allows a 70 percent deduction if the recipient corporation owns less than 20 percent of the distributing corporation’s stock, an 80 percent deduction for 20 percent to 80 percent ownership of the distributing corporation, and a 100 percent

corporation that does not control another corporation in which it holds stock cannot cause it to distribute earnings.

In the absence of a dividend distribution, it is possible to realize the value of that earnings claim by a sale or exchange. The Internal Revenue Code, and its predecessors, has not allowed an exemption from tax on a corporation's sale or exchange of stock of another corporation. That results in a degree of multiple taxation on intercorporate stock holdings that is clearly inconsistent with the policy underlying the dividends received deduction.

That treatment of stock sales by corporations can be fully rationalized based on the need to address conflicting policy considerations. In the absence of corporate gain recognition on the disposition of corporate stock, individuals could defer taxation of stock sales by holding all of their corporate stock via incorporated pocketbooks, buying and selling shares through stock holding companies. Stock appreciation would not be taxed until extracted from the holding company as a distribution.¹³⁶ Moreover, in some, perhaps many, cases it would not be taxed at all because of the step-up in basis on death.¹³⁷ A desire to impose at least one level of tax on the sale of stock is sufficient by itself to rationalize the taxation of corporations that dispose of corporate stock.¹³⁸

Nevertheless, to the extent that a corporate disposition of corporate stock can be structured to trigger a single shareholder level tax and no further corporate level tax, the needs of a double tax regime are satisfied. As previously noted, the distribution of appreciated stock as a dividend under the *General Utilities* principle, achieved exactly this result of a

deduction for 80 percent or greater ownership. I.R.C. § 243 (2012).

136. From one perspective, the perspective that taxation should be tied to consumption, *see infra* note 150 and accompanying text, such a result would not have been objectionable to the extent that it allowed one investment to be rolled into another without triggering a tax and triggered an individual tax only when value was accessed to fund consumption. Although Congress included elements of consumption taxation in the system, *see infra* notes 159-163 and accompanying text, it did not include this one.

137. At the individual taxpayer's death, the value of the shares would be stepped-up to full value. *See* Revenue Act of 1928, § 113(a)(5), 45 Stat. at 819; I.R.C. §§ 1014, 1022 (2012). The liquidation of the holding company would trigger no taxation at the shareholder level, because the amount realized would be zero. *See* Revenue Act of 1928, § 115(c), 45 Stat. at 822, I.R.C. § 331 (2012). The taxpayers would receive the stock portfolio with a basis equal to its value. *See* I.R.C. § 334(a) (2012). In addition, prior to the repeal of the *General Utilities* principle, there also would have been no corporate level tax, *see supra* notes 119-122 and accompanying text.

138. Another justification for imposing corporate taxation on stock sales is that the sale of a subsidiary's stock can be regarded as the equivalent of the sale of the assets of an unincorporated division, which would be subject to corporate level taxation. That justification is not pertinent here because Monitor was not a subsidiary of United.

shareholder tax and no corporate tax.¹³⁹ The literal application of the reorganization provision,¹⁴⁰ to the extent that it resulted in no corporate tax and a single shareholder level tax, served the same end. In that sense, and to that extent, Hand's assumption that taxation at the United level was normative was wrong, even if one takes double taxation as the appropriate baseline.

A. Basis and Capital Gain Issues

A pair of objections to this analysis needs to be addressed. The first is that this issue is not just whether Gregory was taxed at the individual level, but also the extent and nature of the taxation. The objection is that too much of the value she received was treated as basis¹⁴¹ and that, in a double tax regime, the shareholder tax is normatively taxed at dividend rates and not capital gain rates.¹⁴² With regard to the basis issue, as noted above,¹⁴³ there is no *a priori* principle that would justify preferring one basis allocation over the other. It is necessarily a policy question that must be decided on a case-by-case basis. The literal application of the statute as written was as plausible a resolution to that question as any other.

With regard to the issue of capital gain treatment, it is worth noting that some methods of extracting the value from a corporation have been subject to ordinary tax rates¹⁴⁴ and others make it possible to access capital gain rates.¹⁴⁵ The distinction between them, which is predicated solely on a policy decision to apply different tax treatment to transactions with similar effect, creates a line drawing problem. The

139. See *supra* notes 119-122 and accompanying text.

140. See *supra* notes 16-31 and accompanying text.

141. See *supra* notes 59-63 and accompanying text.

142. See *supra* note 32 and accompanying text.

143. See *supra* notes 74-80 and accompanying text.

144. See, e.g., Revenue Act of 1928, §§ 112(c)(2), 115(a) & (b), 45 Stat. at 817, 822; I.R.C. §§ 301, 302(d), 356(a)(2) (2012).

145. See, e.g., Revenue Act of 1928, §§ 112(c)(1), 115(c), (g) & (h), 45 Stat. at 817, 822-23; I.R.C. §§ 302-304, 331, 356(a)(1) (2012). Since 2003, the benefit of capital gain rates has extended to qualified dividends. See Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, §§ 302-303, 117 Stat. 752, 760-64 (2003) (adopting reduced rate dividend taxation for taxable years beginning through 2008); Tax Increase Prevention and Reconciliation Act of 2005, Pub. L. No. 109-222, § 102, 120 Stat. 345, 346 (2006) (extending reduced rate dividend taxation through taxable years beginning in 2010); Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, § 102, 124 Stat. 3296, 3298-99 (2010) (extending reduced rate dividend taxation through taxable years beginning in 2012); American Taxpayer Relief Act of 2012, Pub. L. No. 112-240, § 102, 126 Stat. 2313, 2318-19 (2013) (making the application of capital gain rates to dividends permanent).

resolution is necessarily arbitrary and resolved not by *a priori* principles but by the choices made in the language of the statute.¹⁴⁶ The literal application of the statute in *Gregory* was just as plausible a manner of drawing that line as any other.

On the other hand, from a perspective that favors double taxation but not multiple taxation, one might rationalize the result in *Gregory* based on the manner in which it drove future such transactions to use the *General Utilities* principle. By denying reorganization treatment, a future equivalent transaction would occur as a direct distribution of stock, triggering no corporate level tax and a full dividend tax at the shareholder level.¹⁴⁷ From this perspective, Hand's opinion could be rationalized as preserving double taxation by driving these stock spin-off transactions to use the *General Utilities* principle. At the same time, the application of *General Utilities* to the distribution of other, non-stock, assets allowed for functional tax integration.

B. Which Option to Choose

This raises the second objection that, regardless of whether the asset spin-off occurred via a distribution protected by the *General Utilities* principle or the literal application of the reorganization provision, a court was not in a position to impose a distinction in treatment depending upon whether the asset spun off was stock in another corporation subject itself to taxation or to some other asset, such as operating assets. A decision that would allow the avoidance of multiple taxation in the former situation would allow the avoidance of double taxation in the latter situation. This represents an alternate rationalization, that the imposition of the multiple tax in some cases is desirable to preserve the double tax in others.

Either rationalization of Hand's analysis, however, is predicated on the court making a policy choice on its own authority. Even if one is convinced that double taxation is the overriding norm, it is not obvious that this principle overrides the desire to avoid multiple taxation. Here again, as in the case of double taxation vs. integrationism, the statute Congress produced was a compromise between competing policies. The dividends received deduction served to mitigate multiple taxation¹⁴⁸ but

146. See, e.g., Stanley S. Surrey, *Definitional Problems in Capital Gains Taxation*, 69 HARV. L. REV. 985 (1956); Robert C. Clark, *The Morphogenesis of Subchapter C: An Essay in Statutory Evolution and Reform*, 87 YALE L. J. 90, 110-17 (1977); Polito, *supra* note 75, at 543-47.

147. See *supra* notes 119-127 and accompanying text.

148. See *supra* notes 131-135 and accompanying text.

did not fully resolve the issue.¹⁴⁹ The literal application of the statute as written represents the legislative compromise between the two policies.

Yet there was another alternative open to Hand besides choosing which of the two competing policies was more important. The literal application of the statute would have left to Congress the policy questions of whether these fine distinctions in result justify creating a more nuanced statute. Is the desire to tax Gregory as if she had received a dividend sufficiently important to justify denying tax-free treatment at the corporate level? Or would it have been possible to amend the statute to impose full dividend taxation on the spin-off of marketable shares, while preserving the rest of the reorganization apparatus for other spin-off transactions? Is the desire to impose double taxation on the spin-off of operating assets sufficiently important to impose cascading taxation on the spin-off of marketable stock? Each of these policy questions is one that implicitly had an answer in the Revenue Act of 1928, and each of them could have had a different answer later based on the ongoing legislative process.

VI. A CONSUMPTION TAX PERSPECTIVE

From a consumption tax perspective, accretion to asset value should not be taxed until that value has been realized and consumed. Even in a system in which it is not practical to track cash realizations through into investment in other assets, it is clear that from a consumption tax perspective the direct rollover from one investment into another should not trigger taxation.¹⁵⁰ Based on that logic, the division of Gregory's investment in one corporation, United, into an investment in two corporations, United and Averill, should not have triggered any taxation. Moreover, the liquidation of Averill also had the effect of rolling one investment into another, the Monitor stock. From a consumption tax perspective, the earliest time at which Gregory should have been subject to tax was the sale of the Monitor stock, which happened to be the same day as the liquidation of Averill. From that perspective, therefore, the literal application of the statute as written produced the appropriate result.

A. "But, It's an Income Tax, Isn't It?"

Here, one must anticipate an objection that, "It's an income tax

149. See *supra* notes 136-138 and accompanying text.

150. See, e.g., Andrews, *Consumption Tax*, *supra* note 7, at 151-52.

system, not a consumption tax system.” If, however, income is equated with accretion to wealth, as that statement assumes, the system has never been a pure income tax system. The actual tax base is, and always has been, a hybrid of income in the accretionist sense and consumption.

The familiar Haig-Simons definition of the accretionist paradigm would equate income with “the algebraic sum of (1) the market value of the store of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question.”¹⁵¹ Yet there is no *a priori* reason to equate income and accretionism. Irving Fisher famously argued that income should not include accretions to asset value.¹⁵² That the Haig-Simons definition appropriates the term “income” to refer to accretionism and that the actual tax self-identifies as an income tax does not resolve the problem of understanding the tax base produced by the statutory text or identify the ideal tax base.

In the interpretive context, the real issue is not the semantic one of defining the term income in the abstract but of identifying the contours of the tax base on which Congress has chosen to impose taxation. The tax law is a self-conscious artifact of human construction, designed to allocate the material costs of government based on some principle of justice, prominent examples of which are taxpayers’ ability to pay,¹⁵³ or the benefits taxpayers receive in exchange for their taxes,¹⁵⁴ or the

151. HENRY C. SIMONS, *PERSONAL INCOME TAXATION* 50 (1938); see also ROBERT M. HAIG, *The Concept of Income-Economic and Legal Aspects*, in *THE FEDERAL INCOME TAX* 1, 7 (Robert M. Haig ed., 1921) (“Income is the money value of the net accretion to one’s economic power between two points of time.”).

152. Irving Fisher, *Are Savings Income?*, 9 *AM. ECON. ASS’N Q.* 21 (1908).

153. See, e.g., SIMONS, *supra* note 151, at 5-15 (“The greater part of what has been written about justice in taxation has been couched in terms of sacrifice. This concept, along with ‘ability’ and ‘faculty,’ is a more or less legitimate progeny of ‘utility’”); Alfred G. Buchler, *Ability to Pay*, 1 *TAX L. REV.* 243, 243 (1946) (“A slogan popular for centuries in tax discussions has been the phrase ‘ability to pay.’ To many persons ability to pay is synonymous with justice in taxation. When one attempts to define it, he encounters a task as difficult, indeed, as the definition of such concepts as ‘truth,’ ‘beauty,’ and ‘justice.’”); Walter J. Blum & Harry Kalven, Jr., *The Uneasy Case for Progressive Taxation*, 19 *U. CHI. L. REV.* 417, 480 (1952) (“[I]t is not infrequently urged that ability to pay is the cardinal criterion of tax justice.”); Jeffrey A. Schoenblum, *Tax Fairness or Unfairness? A Consideration of the Philosophical Bases for Unequal Taxation of Individuals*, 12 *AM. J. TAX POL’Y* 221, 233 (1995) (“The predominant alternative to benefit theory in scholarly discourse has been the ability to pay theory of taxation. Pursuant to this theory, an equitable system of taxation is considered linked to the capacity of a person to bear the tax bill.”). For purposes of this discussion, one need not make the fine distinction that some authors have made between ability to pay theory, sacrifice theory, and utility theory. See also Blum & Kalven, *supra* at 455-86.

154. See, e.g., SIMONS, *supra* note 151, at 3-5 (“A familiar answer to this question is found in the doctrine of taxation according to benefit.”); Blum & Kalven, *supra* note 153, at 451 (“Since it is obvious that each taxpayer derives some benefits from the operation of government, the magnitude

redistribution of society's material wealth.¹⁵⁵ The tax law cannot directly pursue its goals, however, because the satisfaction of those policies is not susceptible of direct measurement. Because the tax law cannot address its substantive policy goals directly, it uses measurable economic concepts as proxies.

The question is whether accretionism or consumption taxation is the better proxy to the underlying policy goal. Professors William Andrews and Alvin Warren famously debated the issue in a series of law review articles.¹⁵⁶ The question continues to be debated,¹⁵⁷ as it was in

of such benefits suggests itself as a standard for distributing the tax burden.”); Richard A. Epstein, *Taxation, Regulation, and Confiscation*, 20 OSGOODE HALL L.J., 433, 438 (1982) (Arguing, that interpreting the Fifth Amendment as prohibiting taxation producing a disproportionate impact would “help prevent the creation of a situation in which the proponents of a tax . . . enjoy benefits in excess of cost while others are made to bear costs in excess of benefits.”); RICHARD A. EPSTEIN, *TAKINGS: PRIVATE PROPERTY AND THE POWER OF EMINENT DOMAIN* 285-305 (1985) (subjecting a number of taxes to a disproportionate impact analysis); Schoenblum, *supra* note 153, at 225 (“A common assertion of defenders of differences in taxation has been the contention that higher income earners ought to pay more because they have benefited more from the society and the services afforded by the government.”).

155. See, e.g., SIMONS, *supra* note 151, at 15-19 (“The case for drastic progression in taxation must be rested on the case against inequality— on the ethical or aesthetic judgment that the prevailing distribution of wealth and income reveals a degree (and/or kind) of inequality which is distinctly evil or unlovely.”); Blum & Kalven, *supra* note 153, at 486-90 (“A progressive tax on income necessarily operates to lessen the inequalities in the distribution of that income.”); JOHN RAWLS, *A THEORY OF JUSTICE* 277-79 (1971) (“[T]here is a distribution branch [of the institutions of distributive justice]. Its task is to preserve an approximate justice in distributive shares by means of taxation and the necessary adjustments in the rights of property The purpose of these levies . . . is . . . gradually and continually to correct the distribution of wealth and to prevent concentrations of power detrimental to the fair value of political liberty and fair equality of opportunity”); Andrews, *Consumption Tax* *supra* note 7, at 1165 (concluding that the “primary, intended, real effect of any general revenue-raising tax is to curtail some part of the private consumption of economic resources that would otherwise occur, in order to free those resources for public use, including redistribution to the poor.”).

156. See, e.g. Andrews, *Consumption Tax*, *supra* note 7; Alvin C. Warren, Jr., *Fairness and a Consumption-Type or Cash Flow Personal Income Tax*, 88 HARV. L. REV. 931 (1975) [hereinafter Warren, *Fairness*]; William D. Andrews, *Fairness and the Personal Income Tax: A Reply to Professor Warren*, 88 HARV. L. REV. 947 (1975); Alvin C. Warren, Jr., *Would a Consumption Tax be Fairer than an Income Tax?*, 89 YALE L.J. 1081 (1980).

157. See, e.g. MICHAEL J. GRAETZ, *THE DECLINE (AND FALL?) OF THE INCOME TAX* (1997); LAWRENCE S. SEIDMAN, *THE USA TAX: A PROGRESSIVE CONSUMPTION TAX* (1997); John K. McNulty, *Flat Tax, Consumption Tax, Consumption-Type Income Tax Proposals in the United States: A Tax Policy Discussion of Fundamental Tax Reform*, 88 CAL. L. REV. 2095 (2000); Arthur Cockfield, *Income Taxes and Individual Liberty: A Lockean Perspective on Radical Consumption Tax Reform*, 46 S.D. L. REV. 8 (2001); Mitchell L. Engler, *A Progressive Consumption Tax for Individuals: An Alternative Hybrid Approach*, 54 ALA. L. REV. 1205 (2003); Daniel S. Goldberg, *The U.S. Consumption Tax: Evolution, Not Revolution*, 57 TAX LAW. 1 (2003); Edward J. McCaffery, *A New Understanding of Tax*, 103 MICH. L. REV. 807 (2005); Mitchell L. Engler, *Progressive Consumption Taxes*, 57 HASTINGS L.J. 55 (2005); Chris W. Sanchirico, *A Critical Look at the Economic Argument for Taxing Only Labor Income*, 63 TAX L. REV. 867 (2010); Edward J. McCaffery, James

the early decades of federal taxation.¹⁵⁸

Transactionalism, the actual income tax regime in which the tax base is measured by completed transactions, is and always has been a hybrid of accretionism and consumption taxation. Accretionism would tax increases in property value as they accrue, and consumption taxation would defer the tax until an “act of consumption.”¹⁵⁹ Early case law questioned whether realized capital gains were to be treated as part of “income” for purposes of the tax at all.¹⁶⁰ Ultimately,

Congress . . . effectively split the difference between the two theories in taxing property [appreciation] Capital appreciation was not income as long as the taxpayer continued to hold the property, but once it was sold or exchanged in a “realization event,” as broadly defined, the previous growth in value would be recognized as taxable income [T]his compromise permitted Congress to tax capital gains while promising to maintain a distinction between paper and real gains—taxing the latter while exempting the former.¹⁶¹

From there Congress moved the compromise further in the direction of consumption taxation by enacting explicit nonrecognition provisions, because “[e]ven the realization [rule] . . . led to the creation of income tax liabilities sooner, in many instances, than Congress deemed wise or appropriate.”¹⁶²

In 1918, Congress allowed for nonrecognition and deferral of taxation in transactions that otherwise triggered realization, providing that:

When property is exchanged for other property, the property received in exchange shall for the purpose of determining gain or loss be treated as the equivalent of cash to the amount of its fair market value, if any; but *when in connection with the reorganization, merger, or consolidation of a corporation a person receives in place of stock or securities owned by him new stock or securities of no greater aggregate par or*

R. Hines, Jr., *The Last Best Hope for Progressivity in Tax*, 83 S. CAL. L. REV. 1031 (2010); Lawrence Zelenak, *Debt-Financed Consumption and a Hybrid Income-Consumption Tax*, 64 TAX. L. REV. 1 (2010).

158. See *supra* notes 151-152, and accompanying text.

159. ROBERT H. MONTGOMERY, *Reorganizations and the Closed Transaction*, in THE FEDERAL INCOME TAX 114, 135 (Robert M. Haig, ed., 1921).

160. See *Brewster v. Walsh*, 268 F. 207, 213-15 (D. Conn. 1920); *Lynch v. Turrish*, 247 U.S. 221, 231 (1918).

161. BANK, *supra* note 70, at 123. See also Andrews, *Consumption Tax*, *supra* note 7, at 1129.

162. LAWRENCE H. SELTZER, THE NATURE AND TAX TREATMENT OF CAPITAL GAINS AND LOSSES 42 (1951).

*face value, no gain or loss shall be deemed to occur from the exchange, and the new stock or securities received shall be treated as taking the place of the stock, securities, or property exchanged.*¹⁶³

From an accretionist perspective, the reorganization provision is not justifiable, from a consumption tax perspective it is too narrow.

The contours of this compromise continued to evolve in the following years. In 1924, Congress clarified that nonrecognition applied not just to individuals, but also to the corporation's party to a reorganization.¹⁶⁴ By the time of Gregory's transactions, nonrecognition treatment had been extended to like-kind exchanges,¹⁶⁵ stock-for-stock exchanges in a single corporation,¹⁶⁶ transfers to a corporation controlled by the transferor,¹⁶⁷ and transactions in connection with reorganizations, more elaborately defined to provide that:

The term "reorganization" means (A) a merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or substantially all the properties of another corporation), or (B) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its stockholders or both are in control of the corporation to which the assets are transferred, or (C) a recapitalization, or (D) a mere change in identity, form, or place of organization, however effected.¹⁶⁸

In addition, nonrecognition was extended to include involuntary conversions¹⁶⁹ and stock dividends.¹⁷⁰ To the extent that a consumption tax is viewed as equivalent to a tax that exempts the return to capital,¹⁷¹ any move toward reducing the effective tax rate on capital income may be considered a step towards the consumption tax model.¹⁷² In that sense, preferential rates for long-term capital gains¹⁷³ and the step-up in basis of property acquired from a decedent¹⁷⁴ may be seen as examples

163. Revenue Act of 1918, ch. 18, § 202(b), 40 Stat. 1058, 1060 (emphasis added).

164. Revenue Act of 1924, ch. 234, § 203(b)(3), 43 Stat. 263, 256.

165. Revenue Act of 1928, § 112(b)(1), 45 Stat. at 816.

166. Revenue Act of 1928, § 112(b)(2), 45 Stat. at 816.

167. Revenue Act of 1928, § 112(b)(5), 45 Stat. at 816-17.

168. Revenue Act of 1928, § 112(i), 45 Stat. at 818.

169. Revenue Act of 1928, § 112(f), 45 Stat. at 817.

170. Revenue Act of 1928, § 115(f), 45 Stat. at 822.

171. See Warren, *Fairness*, *supra* note 156, at 938-41.

172. See Andrews, *Consumption Tax*, *supra* note 7, at 1131-35.

173. Revenue Act of 1928, § 101, 45 Stat. at 811-12; I.R.C. § 1(h) (2012).

174. Revenue Act of 1928, § 113(a)(5), 45 Stat. 819; I.R.C. §§ 1014, 1022 (2012).

of consumption-tax thinking.¹⁷⁵

In the generations since then, the compromise between accretionism and consumption taxation has continued to evolve. In some respects, it has moved nearer to accretionism, such as the imposition of additional restrictions on the availability of reorganization treatment,¹⁷⁶ and the adoption of mark-to-market accounting for dealers in securities.¹⁷⁷ In other respects, it has moved nearer to the consumption tax ideal. Nonrecognition is available for contributions to partnerships,¹⁷⁸ and for most partnership distributions of property.¹⁷⁹ Other clear examples are the exclusion from taxable income or deductibility of amounts used for retirement savings,¹⁸⁰ educational IRAs,¹⁸¹ and medical savings accounts.¹⁸² The adoption of accelerated depreciation, to the extent that it advances the transactionalist tax toward the full expensing of investments, is a movement toward consumption tax treatment.¹⁸³

The balancing point of the compromise moves along the spectrum between accretionism and consumption taxation as the legislative winds change. The reorganization provision of the Revenue Act of 1928 was a large piece of that compromise, as it existed at the time. Hand's opinion creating the business purpose requirement unilaterally moved the balancing point of Congress's compromise. In a tax system that was, and is, a legislative compromise between accretionism and consumption taxation, the judicial creation of a new mechanism to reset the balancing point of that compromise was not justified based on the court's own preference for one side of the pertinent policy debate. Here again, that is especially true given that the carefully crafted legislative text bore no indication at all of a Congressional command for a business purposes requirement.

175. Another such example is the exclusion from income of gain on owner-occupied housing. I.R.C. § 121 (2012).

176. I.R.C. §§ 355, 368 (2012).

177. I.R.C. § 475 (2012).

178. I.R.C. § 721 (2012).

179. I.R.C. § 731 (2012).

180. I.R.C. §§ 401-409 (2012).

181. I.R.C. § 530 (2012).

182. I.R.C. § 220 (2012).

183. See Anthony P. Polito, *Fiddlers on the Tax: Depreciation of Antique Instruments Invites Reexamination of Broader Tax Policy*, 13 AM. J. TAX POL'Y 87, 96-101 (1996).

B. Basis and Capital Gain Issues

A further pair of objections to this analysis needs to be addressed. The first is that under a pure consumption tax the entire proceeds of the sale of the Monitor stock would have been taxed, and therefore too little of the proceeds were taxed as a consequence of the reduction of those proceeds by a portion of Gregory's basis in the United stock allocated to the Monitor stock in Gregory's hands. In an idealized consumption tax system, assets would not have basis. The full amount of value extracted from assets and consumed in any given year would be added to the individual's tax base or taxable "income." At the same time, the reason that there would be no need to keep track of basis is that the full amount of value invested into any asset would be deducted from the individual's tax base.¹⁸⁴

Basis accounting exists in a transactionalist system precisely because it is a hybrid of income taxation and consumption taxation. In the transactionalist system, basis represents the portion of an amount realized on the disposition of an investment asset that is deemed to be a return of the taxpayer's capital. That capital has previously been subject to taxation. Only the excess over that return of capital is subject to taxation. Thus, some consumption is not taxed as it occurs, because it is deemed to be out of tax-paid amounts, that is amounts already subject to inclusion in the tax base.¹⁸⁵ From a consumption tax perspective, therefore, basis reflects amounts that have already been pre-taxed because they were previously included in the tax base without having been consumed.¹⁸⁶

Gregory's basis in the United stock was \$350,000.¹⁸⁷ From a

184. See Andrews, *Consumption Tax*, *supra* note 7, at 1151-53. In such a system, if Gregory reinvested the entire proceeds of the Monitor stock sale in the same taxable year, then none of the proceeds should have been taxable that year. In the absence of any information that she did reinvest those proceeds, however, this analysis proceeds on the assumption that none of the proceeds were reinvested and were instead entirely consumed.

185. Some of it may have been intentionally tax-forgiven; for example, the stepped up basis on inherited property, I.R.C. § 1014 (2012). In that case, it is best seen as tax-paid capital that has been taxed as a policy decision at a zero percent rate. To the extent that these amounts are reflected in basis, they are appropriately referred to as "tax-forgiven" amounts. That does not detract from the fact that they have already been accounted for in the individual's tax base.

186. There is a further complication in the case of the investment of borrowed capital, which is included in basis in anticipation of amounts to be included in the tax base at a later time. See Anthony P. Polito, *Borrowing, Return of Capital Conventions and the Structure of the Income Tax: An Essay in Statutory Interpretation*, 17 VA. TAX REV. 467 (1998); Anthony P. Polito, *The Role of Prescription in the Interpretive Problem of Basis Determination*, 53 TAX LAW. 615 (2000). That nuance is beyond the scope of, and not necessary to address in the context of, this analysis.

187. *Gregory v. Comm'r*, 27 B.T.A. 223, 224 (1932).

consumption tax perspective, that entire amount had been pre-taxed, that is, it had been taxed in anticipation of future consumption. The amount she realized on the Monitor stock spun-off to her from United was \$133,333.33.¹⁸⁸ From a consumption tax perspective, one could easily have adopted a convention that treated the entire amount realized as a return of tax-paid amounts that should not have been taxed again. If that had been the case, none of the Monitor stock proceeds would have been taxed, and Gregory's basis in the United stock would have been reduced by the full amount of the proceeds. Thus, from a consumption tax perspective, the inclusion of any positive amount of those Monitor stock proceeds was more than sufficient because so much of Gregory's capital had been pre-taxed.¹⁸⁹

A second objection relates to the preferential capital gain rate treatment that Gregory asserted, which would presumably not have been available in a consumption tax regime.¹⁹⁰ There is no way to know for sure what cash-flow, if any, would receive the benefit of preferential rates in a consumption tax regime. Even assuming that there would be no such preferential rates, one of the justifications for the capital gain preference is precisely that the transactionalist regime is a hybrid of income taxation and consumption taxation. From a consumption tax perspective, the transactionalist regime taxes so much capital in advance of its consumption, the proper time for that taxation, that in present-value terms much capital appreciation is subject to over taxation if taxed at the full ordinary rates.¹⁹¹

Here again, the application of the capital gain rate as written in the Revenue Act of 1928, simply reflects the balancing point of the legislative compromise between competing tax regimes. Here again, the judicial creation of a new mechanism to reset the balancing point of that compromise was not justified based on the court's own preference for one side of the pertinent policy debate.

VII. CONCLUSION

Learned Hand's opinion took a wrong turn both from multiple policy perspectives and in terms of the problem of statutory

188. *Id.*

189. Gregory purchased the United stock in 1920 and 1921. *Id.* It might well be the case that she earned some of the capital invested before the adoption of the 16th Amendment in 1913. In that case, it should be regarded as tax-paid capital that was at the time subject to a zero percent tax rate.

190. See Andrews, *Consumption Tax*, *supra* note 7, at 1153.

191. See Andrews, *Consumption Tax*, *supra* note 7, at 1131-35.

interpretation. Elsewhere, in an article entitled *Advancing to Corporate Tax Integration: A Laissez-Faire Approach*,¹⁹² I advanced the proposition that although systematic corporate tax integration is unlikely to be enacted in the foreseeable future, integrationism should be regarded as normative. The Laissez-Faire Approach proposes that, to the extent that legal mechanisms serve to prevent self-help corporate tax integration, they are counterproductive, wasting valuable taxpayer, IRS, and judicial resources.¹⁹³

A court does not have authority to create tax integration that Congress has not authorized, and this Article does not claim otherwise. At the same time, the Integrationist Perspective does assert that it is a mistake for courts to block escape hatches from double taxation that Congress has left in the statute. Hand's opinion is mistaken from this perspective because it unnecessarily and counterproductively extends double taxation beyond the scope to which Congress imposed it.

The case for multiple levels of taxation of corporate earnings is even harder to justify. Here again, Hand's opinion is mistaken from a policy perspective. By creating the business purpose requirement, it unnecessarily and counterproductively extends multiple taxation beyond the situations to which the statute makes it unavoidable.

From a consumption tax perspective the policy analysis is much the same. The rollover of capital from one investment to another ought not to trigger taxation. This Article does not advocate that *courts* attempt to create a rollover privilege in circumstances that are not justified by the statute. It was a mistake, however, for the court to create a mechanism to block tax-deferred rollover in circumstances beyond those mandated by the statutory language.

Of course, there is another perspective of all these policy perspectives. That is a perspective that tax should be imposed on all accretions to wealth and that at least two levels of tax should apply to investments in corporate form, perhaps more to the extent that corporations hold shares in other corporations. That is the point at which the Article's analysis turns from policy to the appropriate judicial role in interpretation.

The Revenue Act of 1928 reflected a carefully negotiated legislative compromise among competing perspectives of sound tax policy, as does the modern Internal Revenue Code. It is fair to say that the advocates of no particular policy perspective are fully satisfied. That

192. Polito, *supra* note 5.

193. Polito, *supra* note 5, at 40-42.

is the nature of the legislative process. Competing policy perspectives frequently need to be compromised in order to generate the necessary legislative majorities. As much as a constitution “is made for people of fundamentally differing views,”¹⁹⁴ legislative compromise makes it possible for them to live peacefully together in a single body politic.

This is where Hand’s opinion was most wrong. He elevated his own policy preference above all of the others that went into that carefully crafted legislative compromise, and made it the sole key for the interpretation of the statutory text. His opinion for the Second Circuit reset that compromise in a direction closer to his own preference by imposing on Gregory’s spin-off transaction a business purpose requirement not justified by the statute itself.

In the generations since his decision, Congress has itself imposed requirements on spin-offs that make them less readily available.¹⁹⁵ Over time, the balancing point in Congress shifts. That too is intrinsic to the legislative process, and the balancing point of the evolving compromise that is the Internal Revenue Code naturally shifts as well. The very adoption of those additional restrictions proves that Congress is fully capable of moving the statute in the direction its majorities prefer. Until they do so, however, the best evidence of where they have chosen for the statute to balance among competing policy concerns is, and was, the text of the statute itself.

One might argue that, because Congress had full authority to reverse Hand’s result, the mistaken use of his authority extended only until the next opportunity for Congress to have so done. Moreover, given that Congress did not reverse legislatively, it appears that Hand correctly “guessed” Congress’s desire. However, even setting aside the seemingly likely possibility that judicial precedent creates a degree of inertia in favor of the new judicially created status quo, Hand could equally have “guessed” that Congress desired to have its statute enforced as written. If that were wrong, that error, too, and to the same extent, would have persisted only until the next opportunity to reverse legislatively. That Congress added additional restrictions on the availability of similar spin-off transactions,¹⁹⁶ some of them in reversal of judicial interpretation, indicates that Congress is fully capable of concluding that the statute as written is too liberal in application and calls for additional restrictions. The virtue of “guessing” that the statute

194. *Lochner v. New York*, 198 U.S. 45, 76 (1905) (Holmes, J., dissenting).

195. I.R.C. § 355 (2012).

196. *Id.*

should be applied as written is that it eliminates the need to guess what additional terms Congress would “want” to add to the statute but did not.

Perhaps the clearest statement of the weakness of Hand’s analysis comes from Hand himself.

In my own case the words of such an act as the Income Tax . . . merely dance before my eyes in a meaningless procession; . . . leave in my mind only a confused sense of some vitally important, but successfully concealed, purport, which it is my duty to extract, but which is within my power, if at all, only after the most inordinate expenditure of time.¹⁹⁷

Hand assumed the revenue act contained a single overriding “purport” and therefore failed to see it as a compromise among multiple inconsistent “purports.” This makes his decision wrong, because, again in his own words:

When a judge tries to find out what the government would have intended which it did not say, he puts into its mouth things which he thinks it ought to have said, and that is very close to substituting what he himself thinks right. Let him beware, however, or he will usurp the office of government, even though in a small way he must do so in order to execute its real commands at all.¹⁹⁸

That, above all, is what made the Hand’s judicial creation of the business purpose wrong.

197. Learned Hand, *Thomas Walter Swan*, 57 *YALE L. J.* 167, 169 (1947).

198. LEARNED HAND, *THE SPIRIT OF LIBERTY* 108 (Irving Dillard ed., 1960).

