

The Tax Avoidance Problem in the United States

by Walter J. Blum

Professor of Law

The University of Chicago Law School

The following paper was delivered at the Twelfth Tax Conference of the Canadian Tax Foundation in Winnipeg, Canada, in November, 1958. It is printed here with the kind permission of the Foundation.

I have taken on the task of commenting briefly upon the tax avoidance problem under the United States income taxes.

Let me begin by defining the problem. I conceive of it as centering on the question of what is to be done about efforts of taxpayers to minimize their taxes by arranging their affairs in more or less abnormal or forced ways so as to comply literally with statutory provisions that confer certain tax advantages. Please note that I have narrowed the topic somewhat. Excluded from it are attempts to stretch or distort accounting judgments or classifications in computing taxable income. Also left out are efforts to defraud the government by willfully and knowingly making out a false return, or by manufacturing untrue evidentiary documents, or by doing the numerous



Professor Walter J. Blum.

things that are commonly regarded as tax crimes. My subject concerns the gentle and sophisticated tax dodger who hopes to succeed by taking advantage of the law rather than by disobeying it. Fortunately, I am not called upon to locate a precise line of demarcation between tax avoidance and tax fraud or evasion.

Our campaign against the tax dodger has been anchored mainly in the judiciary and legislature. While the Treasury has attempted to combat avoidance in the promulgation of regulations, this activity has been of secondary importance, except where the statute confers special power on the administrators in avoidance situations. Some commentators have suggested that the most logical way to deal with the whole tax dodger problem would be to invest the Treasury with broad substantive power to refine the statutory rules in response to taxpayer ingenuity. There is, however, virtually no support for undertaking so far reaching a reform in our tax system. On the contrary, the impartiality of the Treasury is still widely questioned.

The courts generally have been in the forefront in dealing with the avoidance problem. From the judicial perspective, the central question can be restated as this: Under what circumstances is formal compliance with the explicit terms of the statute enough to attain a tax advantage which it purports to confer? Obviously this is basically a matter of statutory interpretation. But it is one of peculiarly vital importance for our tax structure. If the courts were to hold the view that form always must prevail (unless the legislature has specified otherwise), tax dodging would be too easy, the public would soon become disturbed, and the voluntary compliance foundation of our system would be weakened. If the courts were to take the extreme opposite view that form need never prevail (unless explicitly provided by statute), tax law would become too uncertain, and the resulting chaos would materially impede business and financial operations. Our courts understandably have chosen a middle ground: form must sometimes prevail but not always. And thus we face the basic judicial problem of under what circumstances is it to prevail?

In reading the innumerable decisions in which this question was at issue, one is not likely to find many comfortable answers. In part the difficulty lies in the rhetoric of saying that a taxpayer is free to arrange his affairs so as to minimize taxes, and that a tax savings motive is immaterial in applying the statutory rules (unless the statute states otherwise). This kind of talk by courts solves nothing. The intent to minimize taxes cannot control the question whether form should prevail because almost all rationally planned business transactions do take taxes into account; and



Three members of the Supreme Court of Illinois are graduates of the Law School. Pictured above, at the dinner for entering students, are, left to right, Justice Walter V. Schaefer, JD'28, Justice Harry B. Hershey, JD'11, and Justice Charles H. Davis, JD'31.

it should be equally plain that if such an intent were not present, there would be no tax dodger problem.

Another part of the difficulty is that decisions often seem to be by invective alone. It appears that the taxpayer loses because something he has done is said to be a "sham" or "artifice," or "device" or even worse. Such a finding might be a sound basis for decision where the taxpayer has represented that he has done something—such as organized a corporation—when in fact he has done nothing of the kind. In the cases we are dealing with, however, the taxpayer in fact has followed the form he has selected, even though he chose it only because of tax considerations. To call one of these transactions a sham is merely a way of stating the conclusion that the form is not controlling, without telling us why adherence to form in the particular case was not acceptable. It probably is also a way of revealing the emotional reaction of the court to the taxpayer's cunning.

A similar trouble is encountered in decisions which go against the taxpayer on the precept that the tax result is to be governed by what was actually done rather than by some declared purpose, or that the transaction under scrutiny is not in fact what it appears to be in form. These are both ways of stating that in the particular case substance is to govern over form, but in themselves they fail to teach us why these cases differ from the many situations in which form does control.

Equally unenlightening are most of the decisions which rest merely on a purported discovery of a more or less particularized legislative intention. Almost always the actual controversy arises because the legislature has not provided a sufficient guide on the point and the court is called upon to repair the omission. Although judicial deference to legislative intention is statesmanlike, it need not obscure the fact that

Continued on page 28

*Tax Avoidance Problem in U. S.—
Continued from page 5*

the court is supplying the rule to govern the situation in issue.

This brings us to the crux of the judicial dilemma: if a legislative pronouncement on the point is lacking (and I pass over what qualifies as such), how should a court decide whether formal compliance with a given rule is enough? I suggest that, in seeking guideposts for implementing legislation, at best the court can only fall back on an examination of the dominant legislative purpose or theme behind the particular rule or the complex of inter-related rules of which it is a part. Unfortunately courts sometimes seem to believe that they should look further afield in this quest for the statutory drift. They then are in danger of discovering only that the policy of the tax law is to raise revenues for the government. (In one opinion the Supreme Court held against the taxpayer because, among other reasons, it found that the section of the statute in question was an aspect "of the comprehensive tax program enacted by the Revenue Act of 1942 to increase the national revenue to further the prosecution of the great war in which we were then engaged"). When a court properly restricts itself to considering the function and purpose of the rule within the framework of the technical law, as revealed by history and legislative surroundings, it is in a position at least to make an informed judgment whether the thrust of the statutory rule is better promoted by rigid adherence to form or otherwise. Nothing more can be asked of the judiciary.

There has been much argument through the years about the judicial legislation which occurs when a court refuses to apply a rule literally. I should like to remark only that giving a rule literal application is likewise a variety of judicial legislation, except that it generally favors the taxpayers and hence is less likely to draw condemnation from their advisors.

The most celebrated instances of judicial limitations being placed upon literal application of the statutory rules involved corporate reshufflings, where, under our statute, different forms for corporate distributions and adjustments carry different tax consequences. It is in this area that the courts frequently restricted availability of the more advantageous form to transactions which were found to have a business purpose and not merely a tax savings motif. Our experience with these judicial versions of the business purpose doctrine nicely illustrate some of the more pronounced consequences of relying on the courts to defeat the tax dodger. Taxpayers are never sure which of the many corporate reshuffling rules will attract the business purpose qualification, and they never know how much (or whose) business purpose

will suffice. If only a modicum of such purpose is enough, the skilled tax practitioner perhaps can be counted on to arrange for its presence. But if a very substantial dose is demanded, the requirement might defeat many transactions which the business community regards as normal. From the Treasury's viewpoint, however, the uncertainty might be other than an evil. Taxpayers are forced to operate without a roadmap for successful tax dodging, and the resulting doubts about the terrain clearly have the effect of reducing the magnitude of the problem by discouraging experimentation with novel transactions.

These characteristics of the judicial approach to coping with tax dodging bring us to the legislative efforts. In the main they have followed three patterns.

One has been to specifically qualify certain rules with a broad directive regarding the consequences of a tax savings motive or an absence of business purpose. Legislative directions of this nature have been given a variety of expressions. The taxpayer is to lose if tax avoidance is found to be a *principal* purpose, or he is to lose only if it is found to be *the principal* purpose, or only if it is found to be a *major* purpose; and furthermore, the words with which the burden of proof is placed on the taxpayer have differed in their forcefulness. All such directives, however, have one thing in common. Regardless of their particular phrasing, they embody a kind of circularity. Improper tax minimization is enjoined by requiring a showing that tax avoidance was not high on the list of motivations. But since the transaction, if it passes muster, does result in a tax advantage, and since we can't expect the rational taxpayer to be

blind to this fact, the courts ultimately are required to distinguish between acceptable tax minimization and unacceptable tax avoidance. It is only a slight overstatement to say that these legislative directives inveigh against tax dodging by instructing the courts to strike down instances in which tax avoidance loomed large, without defining what tax avoidance is. The courts thus must determine when minimization constitutes avoidance, and when such avoidance is so large a component of the motivation as to run afoul of the statutory directive. It can be seen that a legislative business purpose rule operates essentially not unlike its judicial counterpart.

An important exception deserves mention. A statutory directive—and particularly one that explicitly puts discretionary power in the hands of the Treasury—is apt to cause taxpayers to seek prior administrative clearance of transactions which conceivably could run afoul of the anti-avoidance doctrine. Possibly the most significant consequence of the statutory directives is to place enormous leverage in the Treasury through its power to rule or refuse to rule on proposed transactions. The wisdom of this result has not gone unchallenged.

A second legislative pattern has been the enactment of specific rules to meet new tax avoidance situations as they are discovered. This approach, for example, has typified our handling of the capital gain versus the ordinary income question presented by bonds issued at a discount and bonds purchased with coupons detached. Its efficacy depends in large part on the willingness of the legislature to backstop the

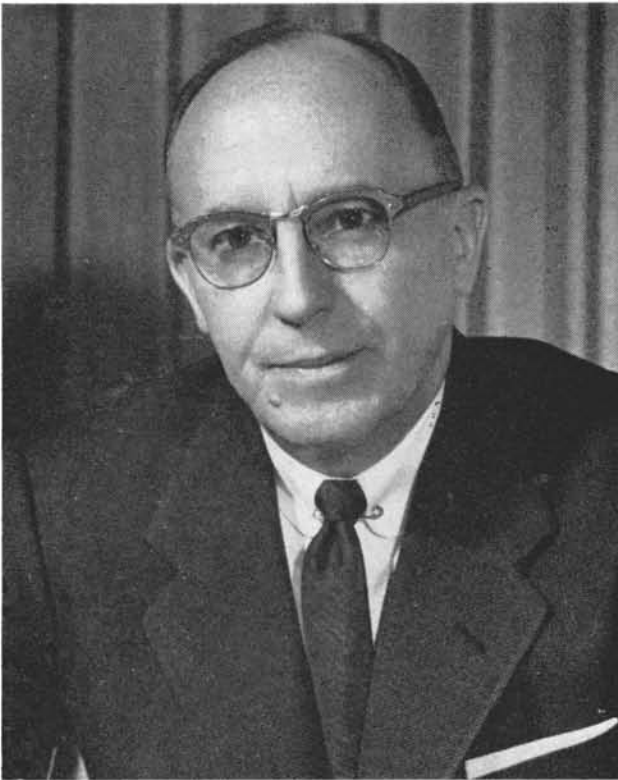
Continued on page 36



Shown above is a Class of 1924 Luncheon held for Hon. Willis H. Ritter, Chief Judge, U. S. District Court for the District of Utah, and a member of the Alumni Board. Responsible for the arrangements was Charles A. Bellows, who is standing, second from left.



During his recent visit to Chicago, Hon. Willis W. Ritter, JD'24, Chief Judge, U. S. District Court, Salt Lake City, lunched with residents of the Law School Dormitory. In the picture above, features of the new Law Buildings are being pointed out to the Judge.



Bernard A. Petric, LLB'30, of Friedrich, Petrie and Tweedle, in Hammond.



Wilbur J. Glendening, JD'34, in practice in Hammond.

*Tax Avoidance Problem in U. S.—
Continued from page 29*

statute year after year with a considerable mass of more or less trivia. Even with a completely cooperative legislature, however, the approach cannot avoid the vexatious problem of the innovator. Should the early bird be allowed the advantage which is being denied to others, so that speed and daring in tax avoidance is rewarded; or should the legislation be made retroactive to cover everybody; or should some compromise position be taken? Generally we have shied away from giving our so-called loophole closing measures an effect prior to their date of enactment or introduction into the legislature, probably in the thought that retroactivity is unsportsmanlike and may even be unconstitutional. But we frequently have accompanied them with an expression of committee intention that no inference about the prior law is to be drawn from the statutory change, thus offering the courts a free hand to make the law for the earlier period. Occasionally we have tried to move in the opposite direction by statements to the effect that the new statutory language is intended only to be declaratory of what is thought to be the existing law. While this procedure may be persuasive with the courts, it cannot serve to bind them.

A third legislative pattern has consisted of dealing more or less comprehensively with a given area of tax law by trying to anticipate the situations which might arise and prescribing specifically on which side of the tax line they fall. The collapsible corporation provisions of our statute are illustrative of this technique. Such highly detailed provisions answer many particular questions which actually arise or might otherwise come up—but at a very real price. Obviously they add considerably to the bulk of the law. It is also evident that the legislature can neither anticipate all the line-testing questions which might arise nor safeguard completely against ambiguity in the many words employed in disposing of the questions covered. Inherent in this technique, moreover, is what some regard as the unfortunate quality of providing tax minimizers with an excellent blueprint of avoidance plans which apparently have received legislative blessing. Specificity and clarity, in brief, make the use of tax savings techniques a lot easier and the code a lot longer.

To this juncture I have considered tax dodging from the standpoint of combating it; I shift now to the perspective of the tax practitioner. While as an informed citizen he might well feel that the artful tax dodge should be checkmated—although I hope he will take care that the cure is not worse than the irritation—as a practitioner he should avoid confusing ethics and common sense. Since it is the

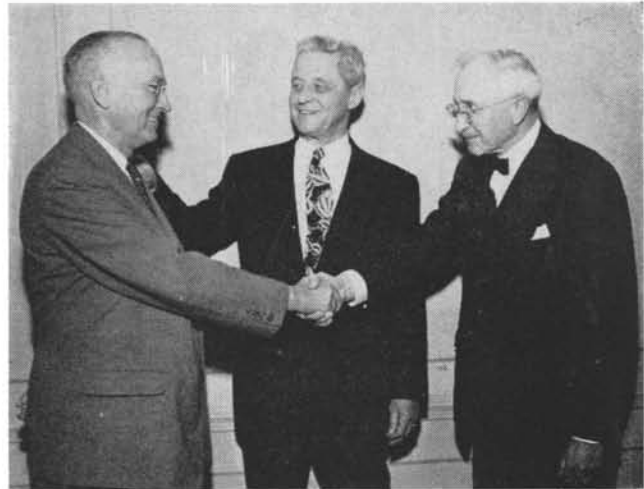
indeterminacy of the legal rules that is at the heart of the tax avoidance problem, I see no moral or ethical inhibitions against trying out new and doubtful schemes. Practitioners need feel no guilt in sending up trial balloons. But I am convinced that frequently such experimentation represents poor judgment and sometimes verges on being foolish. I mean only that all things considered, including an assessment of the chances of success and the costs of losing, the taxpayer's interests would be better served by taking an alternative path. All too often, from the taxpayer's vantage-point, the real vice of being a tax-minimization pioneer is not that the plan ultimately fails to gain the tax advantage sought, but that in choosing the dodge, the taxpayer foregoes other tax opportunities or business or estate planning openings which are unquestionably available to him.

Permit me to add, parenthetically, that I couple the freedom of practitioners to experiment with a broad license in the administrators to shoot at the trial balloons. Furthermore, it may be that our system is deficient in not penalizing unsuccessful experiments more heavily than now in view of the costs which they impose on the whole legal apparatus.

There is one respect in which the pursuit of tax minimization does or should raise an ethical question for practitioners. All too often the willingness to take the gamble rests not alone on the cleverness of the plan but in part on the thought that the facts as stated in the tax return and accompanying documents will not flag the arrangement for the administrators. Thus it is hoped that the plan may succeed because it is passed over without a test on the merits. Even if such incomplete disclosure does not violate legal standards, I submit that it comes precariously close to being unsporting conduct and to trenching on the high ethical standards to which professional men assert they aspire.

It would produce a misleading emphasis to end on this moralistic note. Instead I prefer to remind you of what ultimately lies at the base of the tax avoidance problem. Tax dodging arises in acute form only because our tax statute, in defining taxable income, makes distinctions which depart from a comprehensive measurement of a taxpayer's actual economic enhancement. Thus our tax law distinguishes between a dollar of ordinary income and a dollar of capital gain, a dollar of realized income and a dollar of unrealized income, and so forth. All of us feel and usually act on the feeling that, in maximizing our income or our economic enhancement, a dollar is a dollar. When the tax law distinguishes between dollars, it must do so in terms which are unrelated to the real economic position of the taxpayer and which, in this sense, are arbitrary. The essence of the tax

avoidance problem is found here: where the basic distinction drawn by the law is itself arbitrary, no satisfactory general principle is available for deciding when taxpayers should be defeated in their attempts to move themselves across to the favorable side of that arbitrary line.



At a Class of 1912 luncheon honoring Judge Walter L. Pope, JD'12, U. S. Court of Appeals for the Ninth Circuit, Judge Pope, left, is shown with classmates Judge Elmer J. Schnackenberg, U. S. Court of Appeals for the Seventh Circuit, center, and David Levinson of Chicago, who arranged the meeting.



Hon. Walter L. Pope, JD'12, Judge of the U. S. Court of Appeals for the Ninth Circuit, and a member of the Alumni Board, at lunch with the Editors of the University of Chicago Law Review. At left, Michael B. Douty, of Chicago, A.B. Swarthmore College; and Robert Doan, of Dayton, S.B. Indiana Univ., S.M. Univ. of Illinois; at right, Alan V. Washburn, Editor-in-Chief, of Rapid City, S. D., A.B. Shimer College.