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The Principle of Realism in American and Modern European Jurisprudence

*Benvenuto Griziotti**

American law may be contrasted with European law in that the former is the result of judgments by men appointed to the bench from the ranks of practicing lawyers, who reflect the common sense of justice. European law, on the other hand, is the product of scholarly career judges, who are more likely to follow the technical criteria of positive law, even if they are led to an interpretation that does not coincide with what is felt to be just and equitable. But in recent times, even European jurisprudence has shown a growing tendency to take into account the realities of the situation and the aims of the law in question, so that the letter of the law does not prevent a decision based on the equities of the case, within the framework of the law's aims. This is a survey of the influence of economic reality on American and modern European fiscal law, together with an evaluation of the merits of the European as well as the American approach to this problem.

In the United States, juridical tradition prevails over positive law in reaching decisions. The school of legal thought represented by Roscoe Pound seeks to illuminate the economic, social, and philosophical content of the law. An American judge, it is said, looks for a result which does substantial justice and best corresponds with the aims of the particular law, and then writes an opinion to give his decision the proper legal form. In the field of tax law, this tendency is illustrated by a host of decisions

*The author, formerly Professor of the Science of Finance and of Financial Law at the University of Pavia, Italy, died on November 2, 1956. The teacher of many illustrious students, among them the deceased Minister of the Budget of the Republic of Italy, Senator Ezio Vanoni, he wrote extensively on problems of financial, economic, monetary and credit policy; his attention was also drawn to problems of international finance, economics and politics. The major part of his essays was republished in the volumes: "Essays on The Revival of the Science of Finance and of Financial Law" and "Studies in the Science of Finance and Financial Law." Among his text books, particularly noteworthy is his "First Elements of the Science of Finance."

The article published here was translated from the Italian by Guido Calabresi, third year student at the Yale Law School, and was somewhat revised for publication here by Boris I. Bittker, professor of law, Yale Law School, who lectured at the University of Pavia, on a Fulbright grant, at the invitation of Professor Griziotti in 1955.

which stress the economic reality of the transaction before the court rather than the technical language of the statute. Emphasis on economic reality may be seen in such a case as *Helvering v. Clifford*,¹ taxing the grantor of a short-term trust on its income although he had irrevocably surrendered control of the income for the period of the trust. The same refusal to permit title or other technicalities to override the dictates of equity may be seen in the "family partnership" cases, holding that partnership income is taxable to the person whose personal efforts produced it, rather than to the person entitled to receive it under the partnership agreement, unless the partnership exists in substance as well as in form — unless "the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise."² Another example is the "business purpose" rule of the *Gregory* case,³ holding that a series of transactions that constituted a "corporate reorganization" so far as the mere letter of the law was concerned could not be treated as such for want of economic reality; the Supreme Court refused to confer the status of a true corporate reorganization on what was "simply an operation having no business or corporate purpose — a mere device which put on the form of a corporate reorganization as a disguise for concealing its real character and the sole object and accomplishment of which was the consummation of a preconceived plan, not to reorganize a business or any part of a business, but to transfer a parcel of corporate shares to the petitioner."⁴ Still another example is *Higgins v. Smith*,⁵ refusing to allow the sole shareholder of a corporation to deduct a loss suffered on a sale of property to his own corporation. Many other examples could be adduced.⁶

In Switzerland the method of interpretation according to economic reality is considered by Blumenstein⁷ and in the reports

1. 309 U.S. 331 (1940).

2. *Commissioner v. Culbertson*, 337 U.S. 733 (1949). See also *Commissioner v. Tower*, 327 U.S. 280 (1946), and *Lusthaus v. Commissioner*, 327 U.S. 293 (1946).

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

4. *Id.* at 469.

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

6. E.g., *McWilliams v. Commissioner*, 331 U.S. 694 (1947); *Commissioner v. Laughton*, 113 F.2d 103 (9th Cir. 1940). There are, of course, also cases where the argument of form versus substance has not prevailed: e.g., *Chamberlin v. Commissioner*, 207 F.2d 462 (6th Cir. 1953), cert. denied, 347 U.S. 918 (1954); *Alprosa Watch Corp. v. Commissioner*, 11 T.C. 240 (1948).

7. BLUMENSTEIN, *SYSTEM DES STERERRECHTS* (Germany 1951), translated into Italian by FORTE, *SISTEMA DI DIRITTO DELLE IMPOSTE* (Italy 1954).

of the Federal Tribunal⁸ as a criterion to be adopted to ascertain the economic significance of the phenomenon, when this is required by the law. This criterion comes into play particularly in income tax cases, since the concept of income assumed by the legislator is an economic concept. In particular, unlawful profits are taxable and unlawful expenses are deductible. Furthermore, it finds vast application in decisions on tax evasion. In fact, in the Helvetian Commonwealth tax evasion is attacked directly with special rules holding that legal maneuvers made with the aim of avoiding the tax, in a particular case, shall have no such effect.⁹ Furthermore, theory and practice are in accord in not recognizing the effects of tax evasion in the particular case, that is, in considering the case as if true evasion had not occurred. According to Blumenstein (who accepts a more restricted concept than others), three things are necessary to evasion: subjectively, an intent to avoid or lessen taxes; objectively, an abnormality of the transaction or of its form; and, retrospectively, an actual tax saving.¹⁰ Blumenstein recognizes that greater weight is given to economic reality as a general principle in German legislation than in Swiss. In the latter, for example, according to Blumenstein, emphasis upon general categories of economic concepts is limited by the Swiss constitutional principle of equality of law, which requires a consideration of the special circumstances of each individual case.

In France the criterion of holding strictly to the literal and technical interpretation of the law prevails.¹¹ On the other hand, however, there is often cited the formulation expressed in the conclusions of the Government Commissioner, Corneille, before the Conseil d'État: "Tax law is concerned with questions of fact and not of legal theory."¹² This formulation is certainly significant in its adherence to the principle of economic reality, and was followed in other cases, such as a 1935 judgment of the

8. T.F., 45, I, p. 26; 46, I, p. 184.

9. Tax on Exchanges, arts. 8, 40; Federal Luxury Tax, arts. 9, 20; Executive Ordinance on the Stamp Law, art. 5; Law of San Gallo on Cantonal and City Taxes, art. 2; Protective Tax, arts. 7, 20; Law on Custom Duty, art. 8, with ordinance on the tare.

10. See note 7 *supra*.

11. T.F. 59, I, 284; 64, I, p. 402, 71, I, p. 392; 75, I, p. 60.

12. Judgment of January 21, 1921, D. 1922, 3, 36. Corneille adds: "*Il saisit la matière imposable, là où elle s'y trouve, sans se préoccuper de savoir ce qu'elle vaut en droit.*" Cf. HéBrand, *L'Autonomie de droit fiscal serait-elle un moyen de favoriser les accords internationaux*, in *CAHIER DE DROIT INTERNATIONAL (I.F.A.)*; BASEL, VERLAG FÜR RECHT UND GESELLSCHAFT 49 (1939); JEZE, *COURS DE FINANCES PUBLIQUES* 207 (France 1933); Dufour, *de l'autonomie du droit fiscal*, in *GAZETTE FISCALE* 458 (France 1952).

Conseil d'État which established that "the fiscal authority is sovereign in all that concerns evaluations of fact, being not at all tied down to the formal rights of commercial law."¹³

In England the doctrine, that in interpreting tax laws the substance of the transaction rather than its legal form must be looked at, was at one time established. But the case of *Duke of Westminster v. Commissioners of Inland Revenue* resulted in a decision opposed to such a doctrine—that is that "one must recognize the real legal effect of the transaction."¹⁴ The facts were the following: the Duke, in order to pay a smaller surtax, agreed with several of his employees that he would halve their salaries and make up the difference by guaranteeing payment of an annuity. He did this in order to deduct the value of these annuities from his income subject to surtax. Although sustained in this case, this device was outlawed by the Finance Act of 1946.¹⁵

In Belgium, both in theory and in case law, it has been recognized that tax liability is based on economic reality rather than on legal abstractions.

Income taxes cannot be based either on possibilities or on false appearances, since they cannot be collected except from real income actually realized; and from the moment this fact exists, the State ought not to look to see if the income is legal or not: the tax strikes earnings from gambling or wages, even if they are forbidden by the criminal law.¹⁶ Even with the stamp tax, in which the object of tax is a juristic act, the legislator intends to tax the *economic realities* which follow from the act and not the legal abstraction involved.

But above all it was in Germany, at the end of 1918-19 when Dr. Enzo Becker had to plan the great reform of the German tax system, that the need of fighting fiscal fraud worked through the "appearances" of civil law was seen. Becker found that the major difference between a legal fiction and an actual concealment lay in the economic background. He, therefore, held it

13. Judgment of January 23, 1935, Sirey, 1936, 3, 33. A note by M. L. on this decision in the same journal states the principles that "to say that tax law, by its very nature, strikes questions of pure fact signifies that in public finance facts prevail over legal theory."

14. *Duke of Westminster v. Commissioner of Inland Revenue*, 19 T.C. 490 (1935).

15. McBAIN, PRACTICAL NOTES ON THE LAW OF INCOME TAX 97-98 (England 1950).

16. App. Bruxelles, 1-II-1930, Pas (icrisie), 1930, II, 91.

necessary to have a rule relative to tax evasion stating that "the duty to pay taxes may not be evaded or lessened by abuse of forms or adaptations of the civil code."¹⁷ It would still be necessary to define closely what would be deemed "abuse." On the other hand it is extraordinarily difficult from the point of view of legislative techniques to reduce the types of situations where a tax is meant to apply into a brief formulation that can be employed in determining tax liability. One is thrown back, therefore, on the concepts generally used in civil law. But here the danger arises that these concepts (so old and so well known, in contrast to the new concepts of fiscal law) might be considered to be valid and decisive even in tax law.

To prevent this serious peril, Dr. Enzo Becker added as Article 4 a rule of interpretation, that, "in interpreting tax laws, one must consider their purpose, their economic significance, and the origin of all the circumstances."¹⁸

To this end, Becker put his hopes on the Reichsfinanzhof. These hopes were not disappointed. The injunction to consider their purpose and their economic significance in interpreting fiscal laws, vague as it of course was in itself, brought forth rich fruit in the handling of concepts taken from civil law in the tax field, and in the forming of economic concepts in fiscal law.¹⁹ Thus was assured the development of fiscal law into an autonomous field of law. The sense of realism which pervades all of fiscal law has found here its decisive expression. Becker asserted that he who applies tax laws must take his lead not from formal concepts but from things, from the facts themselves in their true significance.²⁰

From the teachings of Becker and from his work as "divisional president" of the Reichsfinanzhof originated a rich and learned German literature which developed the principle of economic reality, and which was not without influence on Italian doctrine, especially through the work of Ezio Vanoni in his

17. Becker, *Accertamento e sviluppo del diritto tributario tedesco*, in 1 RIV. DIR. FIN. E SC. F. 155-65 (1937). See also Becker, *Applicazione dell'imposta secondo criteri economici obiettivi nella giurisprudenza della Corte Finanziaria del Reich*, 2 RIV. DIR. FIN. E. SC. F. 220 et seq. (Italy 1937).

18. See note 17 *supra*.

19. See note 17 *supra*. Becker discusses the judgment of the Reichsfinanzhof, 5 May 1937, VI A 22937, which determined that transactions and reorganizations have to be handled, for tax purposes, in a way which corresponds to objective economic criteria.

20. See note 17 *supra*.

*Natura e interpretazione delle leggi tributarie (Nature and Interpretation of Fiscal Law).*²¹ Vanoni sets down, as a canon of interpretation of tax laws, the principle that in order to comply with the purpose of the statute, it is necessary to evaluate accurately the economic function of the facts to which the tax law refers. Becker's position was similarly cited and followed in Dino Jarach's important work on the stamp tax.²²

In Italy consideration of the economic facts is fundamental in the study of fiscal law because taxation necessarily is concerned with facts that are obviously economic in nature (income, capital, the transfer of wealth) rather than legal abstractions.

Even before its establishment in other countries, this principle established itself in Italy, where it sank broad and deep roots, giving rise to the principle of economic reality, which influenced both the Italian case law and the theory of law.

The "science of finance and of fiscal law," as taught in Italian universities is, in fact, a reflection of the economo-legal philosophy of Gian Domenico Romagnosi.²³ This philosophy, which bridges the eighteenth and the nineteenth centuries and was reaffirmed by his notable pupils, stands for the position that the study of fiscal law cannot end with juristic formulations because it must consider the political and economic factors which give substance to the financial phenomena involved.

* * *

After this survey, a few general observations may be made.

It is clear that American law is inspired by criteria of optimism, dynamism, and faith that common opinion reflects the equitable and general interest, and that this is true both in the area where case law and precedent are controlling and, as in the tax field, where written law controls and where precedents indicate the interpretations previously adopted. Classic European law, on the other hand, is pessimistic as regards the interpreters of the law and is in a certain sense authoritarian, because a literal application of the written law serves to chain the thought of the judiciary and of the administrator to the opinions prevalent at the time the legislation was adopted, even if the dynamics of the situation would call for an adjustment of the law to a new

21. Vanoni, at 183, 231 *et seq.* (Italy 1932).

22. JARACH, *PRINCIPI PER L'APPLICAZIONE DELLE TASSE DI REGISTRO* (Principles for the application of the stamp duty) 41 *et seq.* (Italy 1937).

23. See "G. D. Romagnosi," 13 *ENCY. SOC. SCI.* 419.

reality. Classic European law is not disturbed if the written law as applied does not correspond with justice, so long as "the law" is formally recognized and followed. In Europe, then, juristic science requires that judicial techniques follow the formal requirements of positive law, rather than the substantial recognition of justice.

These faults of classical European jurisprudence do not become apparent in the application of civil law, since it is an essentially static body of law and can assume without undue difficulty the schema of Roman Law. In the financial field, on the other hand, these faults do manifest themselves, because this field is always subject to dynamic forces which express themselves in a two-fold way, that is, through the continuous change in political viewpoint of the public authorities and in the profound dynamism of economic forces. Because of these forces in the field of public finance, there has been a rapprochement between the controlling criteria of American and European jurisprudence in recent decades in several European countries, in the written law itself, in law as it has been applied, and in legal theory. Nonetheless, it must be recognized that the rapprochement has barely begun in Europe, and that American jurisprudence still surpasses its European counterpart in its recognition of the criteria of realism and of the importance of justice above the mere formal observance of the law.

On the other hand, it is well to put into perspective the excellence of European thought in this field, in countries like Italy, Germany, and to a certain extent Switzerland, in which lands there has been a rebirth of fiscal jurisprudence as a reaction to the technical formalism of classic law. In Italy the legal and economic philosophy of Gian Domenico Romagnosi, even in the first half of the last century, pointed out that law and economics are interdependent. Law presumes a knowledge of the economy; economics a knowledge of a legal framework within which the economy operates. The Italian legislator, who in 1876 extended to all Italian universities the teaching of public finance (first begun in 1859 by Luigi Cossa in the University of Pavia), gave the chair established in the Faculty of Law the name of "Science of Finance and of Financial Law," so that the study of public finance would broaden its scope and provide a scientific basis for the law of finance. This meant that the scope of legal theory in this area was to go beyond the formal task of describing *what*

the law is, to the more substantial task of determining *why* the law is as it is.

The studies which I began in 1914 and which were continued by such notable Italian scholars as Vanoni, Pugliese, Jarach, Maffezoni, Pomini, and Forte, led to a systematic study of the function of the law of public finance, in order to apply the law to concrete cases realistically and with a proper regard for the language of the statute.

Similarly, the judicial revolution promoted in Germany in 1919, by Becker, which caused a new approach to be taken in legislation, jurisdiction, case law, and in fiscal doctrine, as compared to the rigid German fiscal school of legal formalism and positive law, had the result of bringing the case law closer to the real and concrete needs of financial justice and of allowing it to follow the political and economic dynamics of the country.

In Switzerland, Blumenstein, by always keeping in mind the concrete object of the tax, was a teacher of the greatest importance in promoting the progress of fiscal doctrine and case law in his country. But he did not reach the point of completely freeing himself from the chains of legal technicalities and of the traditions of Roman and civil law, and this prevented him from grasping the natural and complete autonomy of fiscal law within the corpus of legal theory.

At the same time one must recognize the great scientific progress of American case law, to which one must attribute the very great achievement of having defined more clearly and fundamentally the concept of taxable wealth and of identifying the elements which must be subtracted in reaching the concept of taxable income, always with full recognition of the concrete needs of economic life. The result of this careful work of American case law is reflected in legislation and in the science of public finance, both of which have come to stand on a very high plane in comparison with fiscal legislation and the science of public finance in Europe. This has occurred, it is true, because of the different circumstances of Europe and America as a result of two world wars. America has risen to the heights of prosperity, which has favored the development of centers of scientific study, while Europe has fallen into a period of deep depression, during which the progress of science has suffered. As a consequence of the development of American case law, American legal theory

has made great strides in the definition of taxable income. The science of public finance has also been enriched in America by technical studies in business economics.

But a bridge between financial theory and the law of finance does not exist, with the result that the science of public finance in the United States is concerned primarily with research in the economics of finance, which has been an especially intriguing field because of the extent of government intervention in the economy since the 1929 depression. But the science of public finance has not broadened itself to the point of deepening the study of the scientific problems involved in the application of fiscal law. Thus, American fiscal law and the science of public finance, though having points of tangency, have followed divergent roads.

Perhaps it is appropriate to suggest that great progress would result if the study of public finance in the United States could be joined to the study of law, broadening the content of the science of public finance and producing a more systematic examination of the case law.

In Europe, on the other hand, a broader and more rapid evolution of the classic, formal schema of positive law towards a modern conception of legal science and jurisprudence is to be desired, especially in the area of public finance, so that it may take into account the political and economic dynamics of the circumstances of the taxpayer.

Perhaps this brief study of American and European fiscal law has indicated the usefulness, for both Europe and America, of a better knowledge of each other's case law and legal theory in the fiscal field, in order to deepen and perfect the study of the resolution of disputes between taxpayers and the fiscal authorities.