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Stephen B. Cohen

Georgetown University Law Center, cohen@law.georgetown.edu

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Thurgood Marshall: Tax Lawyer

STEPHEN B. COHEN*

The title—which may surprise readers—is not an oxymoron. During his twenty-four years on the Supreme Court, Justice Thurgood Marshall wrote better opinions on the law of federal income taxation than any of his fellow Justices. This is, of course, a subjective appraisal which others may dispute. Nevertheless, from two decades of teaching federal income taxation, I am convinced of the quality of Marshall's work.

However his work is rated, Marshall's impact on federal income tax law seems indisputable. One indicator is that leading casebooks in the field often include more opinions by him than by any other Supreme Court Justice, past or present, with the exception of Justice Harry Blackmun.¹ Even the seasoned tax specialist may be surprised and impressed by the complete list of Marshall's Supreme Court tax opinions, which include such landmark cases as *United States v. Davis*,² *United States v. American Bar Endowment*,³ *Arkansas Best Corp. v. Commissioner*,⁴ *Hernandez v. Commissioner*,⁵ and *Cottage Savings Ass'n v. Commissioner*.⁶

This essay discusses Marshall's contributions to the law of federal income taxation in four important areas: form and substance, capital gains, realization, and charitable contributions.⁷

I. FORM AND SUBSTANCE

The issue of form and substance pervades the law of federal income taxation.⁸ "The extent to which taxpayers are free to minimize their tax obligations by choosing one legal form rather than another," notes one

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1. See, e.g., WILLIAM ANDREWS, BASIC FEDERAL INCOME TAXATION (4th ed. 1991); JAMES J. FREELAND ET AL., FUNDAMENTALS OF FEDERAL INCOME TAXATION (1988).

2. 397 U.S. 301 (1969).

3. 477 U.S. 105 (1968).

4. 485 U.S. 212 (1987).

5. 490 U.S. 680 (1989).

6. 111 S. Ct. 1503 (1991).

7. Each of the four subjects raises enough hard issues to deserve a separate, lengthy article. It is hard to do justice to any of the subjects in a short essay of this nature. Thus, the discussion of each will of necessity be somewhat selective and cursory.

8. See, e.g., BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 4.3.3 (2d ed. 1989) (survey of numerous areas of federal tax law affected by form versus substance issue).

commentator, “has preoccupied lawyers and administrators since the inception of the federal income tax.”⁹ Sometimes, courts permit the taxpayer’s chosen form to control tax results and refuse to permit the Internal Revenue Service (IRS) to recast the transaction based on its substance.¹⁰ At other times, courts do not allow the taxpayer’s form to control and allow the IRS to recast the transaction as involving a different form.¹¹

Skepticism marked Marshall’s work in this area. He questioned the conventional wisdom that the taxpayer’s motive or purpose was relevant to deciding whether the IRS was entitled to disregard the taxpayer’s form. Moreover, he doubted that any general, overarching rule could be devised to determine when the taxpayer’s form should be respected and when it could be recast.

Marshall’s views on form and substance can be usefully contrasted with the test endorsed by an earlier Supreme Court opinion in *Gregory v. Helvering*.¹² *Gregory* formulated what has become a general rule on form and substance¹³ and made the focus of its rule the taxpayer’s motive or purpose. According to *Gregory*, the critical factor for determining whether the taxpayer’s form controls is whether the taxpayer had a business purpose, other than avoiding taxes, for choosing that form.¹⁴ If the taxpayer had a nontax-avoidance business purpose, then the taxpayer’s form should determine the tax consequences of the transaction. If the taxpayer did not have such a purpose, then the IRS may calculate the tax due by recasting the transaction’s form.

Gregory’s so-called “nontax business purpose test” has been cited as the basis of decision in literally hundreds of form and substance cases over the decades.¹⁵ Its prolificacy notwithstanding, the test’s authority and influence are somewhat astonishing, when one begins to note its obvious defects.

To start, the test is difficult to enforce. Evidence of purpose is usually

9. Marvin A. Chirelstein, *Learned Hand’s Contribution to the Law of Tax Avoidance*, 77 *YALE L.J.* 440, 440 (1968).

10. *See, e.g.*, *United States v. Cumberland Pub. Serv. Co.*, 338 U.S. 451, 455 (1950).

11. *See, e.g.*, *Commissioner v. Court Holding Co.*, 324 U.S. 331, 324 (1945).

12. 293 U.S. 465 (1935).

13. *See* BITTKER & LOKKEN, *supra* note 8, ¶ 4.3.4, at 4-44.

14. “[F]ixing the character of the proceeding by what actually occurred, what do we find? Simply an operation having no business or corporate purpose” 293 U.S. at 469.

15. *See, e.g.*, *National Carbide Corp. v. Commissioner*, 336 U.S. 442, 438 n.20 (1949); *Bohrer v. Commissioner*, 945 F.2d 344, 347 (10th Cir. 1991); *Kirckman v. Commissioner*, 862 F.2d 1486, 1490 (11th Cir. 1989); *Friedman v. Commissioner*, 869 F.2d 785, 791 (4th Cir. 1989); *Estate of Schneider v. Commissioner*, 855 F.2d 435, 438 (7th Cir. 1988); *Paccar, Inc. v. Commissioner*, 849 F.2d 393, 397 (9th Cir. 1988); *Owens v. Commissioner*, 568 F.2d 1233, 1237 (6th Cir. 1977); *Smith v. Commissioner*, 537 F.2d 972, 975 (8th Cir. 1976); *Phillips Bros. Chem., Inc. v. Commissioner*, 435 F.2d 53, 57 (2d Cir. 1970); *Blueberry Land Co. v. Commissioner*, 361 F.2d 93, 100 (5th Cir. 1966); *Weller v. Commissioner*, 270 F.2d 294, 296-97 (3d Cir. 1959); *Granite Trust Co. v. United States*, 238 F.2d 670, 674 (1st Cir. 1956).

within the control of the taxpayer.¹⁶ Skillful lawyers are adept at constructing and documenting nontax business purposes simply in order to qualify a transactional form under the business purpose test.¹⁷ Counsel can usually advise the taxpayer in the early stages of a transaction to create a paper trail demonstrating the requisite nontax business purpose. Thus, the test tends to allow the well-advised taxpayer's form to control and to penalize the taxpayer who fails to obtain the services of skilled tax counsel.¹⁸

Furthermore, unless every assertion of nontax business purpose is to be accepted, the business purpose test requires judges to decide which asserted business purposes are valid and which are not. This decision may require specialized knowledge in commerce and finance that may exceed the competence of most judges.

Finally, *Gregory* never really explained the logical relevance of the existence of a nontax business purpose to whether the taxpayer's form should control. Nor is the relevance obvious. Taxation, after all, is generally a matter of objective economic circumstances. Taxpayers in similar economic cir-

16. See RANDOLPH E. PAUL, *SELECTED STUDIES IN FEDERAL TAXATION* 301 (2d series 1938):

[S]uch tests actually stack the cards [against the Commissioner]; the advantage of sweeping definitions and of whatever presumptions may be available to the government will remain more than offset by the fact that the evidence as to motive is almost entirely in the possession of the taxpayer, unless psychology devises a better mental X-ray than has so far been discovered.

17. See Arthur M. Michaelson, "*Business Purpose*" and *Tax-Free Reorganization*, 61 *YALE L.J.* 14, 25 (1952) ("It is an open secret that business purposes are often manufactured in the offices of attorneys.").

18. In federal taxation, subjective tests of purpose or intent have proven notoriously difficult to administer because of the inherent strategic advantage such tests provide taxpayers. Marshall himself referred to this problem in *Arkansas Best Corp. v. Commissioner*, 485 U.S. 212 (1987). See discussion *infra* Part II.C. For this reason, there has been a trend in some areas of the tax law toward replacing subjective tests of taxpayer liability with more easily administered objective standards.

One area of tax law in which the trend toward objective tests can be seen is the deductibility of educational expenses. Until 1967, the test for deductibility of educational expenses depended on the taxpayer's intent. If the taxpayer intended to qualify for a new trade or business or a substantial advancement in her position, then educational expenses were not deductible. Treas. Reg. § 1.162-5(b) (1960) (prior to amendment by T.D. 6918, 32 Fed. Reg. 6697 (1967)). However, if the taxpayer intended simply to improve her skills in her existing trade or business and did not intend to enter a new trade or business or substantially advance in her position, then educational expenses were deductible. *Id.* § 1.162-5(a). Under the approach mandated by the regulation, the expenses could be deductible even if the education in fact did qualify the taxpayer to enter a new trade or business. See *Greenberg v. Commissioner*, 367 F.2d 663 (1st Cir. 1966) (expenses incurred in psychoanalysis training for psychiatrist who intended to remain a psychiatrist were deductible even though training qualified taxpayer in new specialty). The current test is objective. Educational expenses are deductible only if the training does not qualify the taxpayer for a new trade or business, irrespective of what is intended. Treas. Reg. § 1.162-5 (as amended in 1967).

There has also been a shift to objective rather than subjective standards for determining the carryover of corporate tax attributes. Congress enacted objective tests in I.R.C. § 382, which largely supplant the tax avoidance motive test of I.R.C. § 269. I.R.C. §§ 269, 382 (CCH 1991).

cumstances should have similar tax burdens. Therefore, the motives behind a taxpayer's actions should be generally irrelevant.

Marshall squarely addressed the issue of form and substance twice, first in 1962 as a circuit court judge in *Nassau Lens Co. v. Commissioner*,¹⁹ and then eight years later when he wrote the Supreme Court's opinion in *United States v. Davis*.²⁰

A. *NASSAU LENS CO. V. COMMISSIONER*

In *Nassau Lens*, Harry Pildes incorporated his sole proprietorship, transferring assets worth \$230,000 to a newly formed corporation, Nassau Lens Co., Inc. (Nassau Lens). In return, Nassau Lens assumed the proprietorship's \$38,000 in liabilities, and transferred to Pildes \$100,000 in debt securities plus \$92,000 in common stock equity.²¹ The principal issue was whether Pildes's closely held debt should be regarded as genuine or recast as stock.²²

Five years earlier, dissenting in *Gilbert v. Commissioner*,²³ Judge Learned Hand had endorsed the business purpose rule as the proper test for determining the validity of closely held debt: "When the petitioners decided to make their advances in the form of debts, rather than of capital advances," Judge Hand wrote, "did they suppose that the difference would appreciably affect their beneficial interests in the venture, other than taxwise?"²⁴ In other words, in creating the debt, did the shareholders have a nontax business purpose?²⁵

The Tax Court, appearing to follow the business purpose test endorsed by Judge Hand, ruled that the closely held debt should be recast as stock if Pildes lacked a nontax business purpose for the allocation of assets between debt and equity.²⁶ Finding that Pildes's only purpose was tax avoidance, the Tax Court decided for the IRS.²⁷ It recast the debt as equity and thereby disallowed the corporation's deduction for interest on closely held debt.

Then sitting as a Second Circuit Judge, Marshall reversed the Tax Court

19. 308 F.2d 39 (2d Cir. 1962).

20. 397 U.S. 301 (1969).

21. *Nassau Lens*, 308 F.2d at 40-42.

22. *Id.* at 44.

23. 248 F.2d 399, 410 (2d Cir. 1957) (Hand, J., dissenting), *cert. denied*, 359 U.S. 1002 (1959).

24. *Id.* at 412.

25. Eight years earlier, Judge Learned Hand explained the business purpose test: "The doctrine of *Gregory v. Helvering* . . . means that in construing words of a tax statute which describe commercial or industrial transactions we are to understand them to refer to transactions entered upon for commercial or industrial purposes and not to include transactions entered upon for no other motive than to escape taxation." *Commissioner v. Transport Trading & Terminal Corp.*, 176 F.2d 570, 572 (2d Cir. 1949), *cert. denied*, 228 U.S. 955 (1950).

26. *Nassau Lens Co. v. Commissioner*, 35 T.C. 268, 272-73 (1960), *rev'd*, 308 F.2d 39 (2d Cir. 1962).

27. *Id.* at 273.

and rejected its use of the business purpose test.²⁸ He noted the practical difficulty courts face in distinguishing valid from invalid business purposes: "A cautious approach in this particular area of tax law is not entirely unjustified. To have each case turn solely on the existence or lack of a business purpose might ultimately involve the courts in inquiries as to what is a justifying business purpose and what is not."²⁹

Marshall also questioned whether the nontax business purpose test was logically relevant to whether closely-held debt should be recast as equity:

It is all very well to say that it makes very little "economic" difference whether the investment here was divided between debt and equity or was entirely allocated to equity. But by the same reasoning, it may make little "economic" difference to Pildes whether he had an unincorporated business or a corporation in which he is the sole stockholder. And if one wanted to carry the argument far enough, presumably the Commissioner would be free to make *ad hoc* attacks on a whole variety of transactions involving closely held corporations. But th[e] Code does not so empower the Commissioner, for it recognizes and treats corporations as separate entities and affords significance to the type of investment chosen in them so long as that investment has substantial economic reality in terms of the objective factors which normally surround the type chosen.³⁰

The business purpose test is particularly ill-suited to resolving whether closely held debt should be accepted or recast as stock. With foresight, a nontax business purpose can virtually always be demonstrated for closely held debt. The most obvious example is the purpose of affording the close corporation stockholder the same priority claim with respect to corporate assets as other unsecured creditors. Pildes's failure to assert such a nontax business purpose in his case is something of a mystery.

Even if the taxpayer's only motive for creating closely held debt is tax avoidance, such a motive—as Marshall recognized—is logically irrelevant to the question of whether the debt form should be respected for tax purposes. The principal tax consequence of closely held debt is to permit a closely held corporation to be treated as if it were an unincorporated business. Interest on closely held debt is deductible by the corporation,³¹ which reduces corporate income to the extent of interest expense, but taxable to the debt-holders, who own the business.³² In effect, there is no separate tax on the corporation as a business entity but merely a one-level tax at the owner level. Thus, the tax avoidance inherent in the use of closely held debt (provided the debt

28. *Nassau Lens*, 308 F.2d at 46.

29. *Id.* at 45.

30. *Id.* at 46.

31. I.R.C. § 163(a) (CCH 1991).

32. I.R.C. § 61(a)(4) (CCH 1991).

bears an adequate rate of interest) is really no greater than the tax avoidance inherent in the decision to operate a business in unincorporated rather than corporate form to begin with.

For decades before *Nassau Lens* was decided, the practice of the IRS and the courts had been to respect closely held debt provided that the corporation's inside debt to equity ratio—when the closely held debt was created—was no more than 3 to 1.³³ Looking at the specific case of *Nassau Lens*, the debt to equity ratio—including both inside and outside debt—was only 138 to 92, or 1.5 to 1. *Nassau Lens*'s total debt to equity ratio was rather modest, less than one-half of the requisite 3 to 1 ceiling ratio for inside debt alone, and therefore should have easily satisfied the IRS and the courts.

Why then did the IRS decide to litigate this case? The answer is that Pildes was attempting to use closely held debt, not simply to cause his business to be taxed as if it were unincorporated, but to *defer* any tax on a significant portion of business income for a period of up to ten years. How was this deferral to be accomplished? The debt securities paid zero stated interest, were issued for a price of \$1,000 apiece, and returned a principal amount of \$1,500 at maturity ten years later.³⁴ All the interest was therefore represented by original issue discount, the \$500 difference between the \$1,000 issue price and the \$1,500 principle amount, payable only when the bonds matured. *Nassau Lens* deducted the interest, as measured by the original discount, ratably over the ten-year term of the debt. Pildes, the debt holder, argued that he should not have to report the interest income until actually paid at the end of the bonds' ten-year maturity.³⁵ Thus, the accrual of interest deductions by *Nassau Lens*, combined with deferral of interest income by Pildes, would have caused business income not to be reported and taxed for up to ten years. Pildes was attempting to avoid taxation of business income by mismatching the corporation's deductions of interest expense with his reporting of interest income. Moreover, he did so at a time when Congress had not yet enacted code provisions to prevent such mismatching.³⁶

33. See BORIS I. BITTKER & JAMES S. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ¶ 4.04 at 4-24 (5th ed. 1987) (a debt to equity ratio that does not exceed 3 to 1 is assumed to withstand judicial scrutiny).

34. *Nassau Lens*, 308 F.2d at 41-42.

35. *Id.* at 42 (in its 1954 tax return, *Nassau Lens* deducted \$4,904.10 as the amortization of the original issue discount on the debentures, while the Pildeses, in their 1954 tax return, did not include any interest income from the debentures).

36. Congress eventually put a stop to this practice by enacting Code provisions designed to prevent the mismatching of interest expense and interest income by a corporation and its debt-holders. I.R.C. §§ 1272-1274 (CCH 1991) (bondholder required to report original issue discount interest income on an economic accrual basis); *cf. id.* § 1274A (debtor and lender permitted to elect to use the cash method for deducting and reporting interest provided stated requirements are met). Today, these provisions would explicitly prevent *Nassau Lens* from deducting interest expense until Pildes reported the interest. If Pildes used the cash method of accounting, then both parties could

Might the IRS have used a more principled and more narrowly focused tool than the business purpose test to challenge the mismatching of interest deductions and interest income in *Nassau Lens*? Although Pildes was, like the corporation, on the accrual method of accounting,³⁷ he had not reported the interest income represented by original issue discount as it accrued. The IRS therefore might have argued that, as an accrual method taxpayer, Pildes had to report interest income as it accrued in order to clearly reflect his income.³⁸

Instead, the IRS tried to apply the business purpose test to the issue of whether closely held debt should be recast as equity, in order to stop the abuse caused by the mismatching of interest expense deductions and interest income for which Congress had not yet enacted an adequate statutory remedy.³⁹ However, the IRS should not have applied the business purpose test to the debt versus equity area, where it had not been applied before, was logically irrelevant, and was in any event available only because of Pildes's apparent failure to claim a plausible business purpose. Marshall thus properly rejected the IRS's attempt at this unprincipled application of the business purpose test.

B. *UNITED STATES V. DAVIS*

Two years after joining the Supreme Court in 1968, Justice Marshall wrote the opinion in *United States v. Davis*,⁴⁰ in which he revisited the question of form and substance that he had addressed earlier in *Nassau Lens*. In *Davis*, a corporation redeemed preferred stock from a shareholder who (with application of attribution rules) was considered as owning one hundred percent of the corporation's stock.⁴¹

A redemption is, in form, a sale of stock by the shareholder to the corpora-

elect to account for interest under the cash method by virtue of section 1274A(c). However, if Pildes used the accrual method of accounting, the election would not be available and he would be required to accrue interest income under section 1272. When *Nassau Lens* was litigated, however, the relevant provisions had not yet been enacted.

Since both *Nassau Lens* and Pildes were on the accrual method of accounting, I.R.C. § 267(a)(2)—which requires matching of interest deductions with interest income in the case of certain related taxpayers and which had already been enacted—did not apply to their case. *Id.* § 267.

37. *Nassau Lens*, 308 F.2d at 40.

38. Code section 446(b) empowers the IRS to change a taxpayer's accounting method if it does not clearly reflect income. I.R.C. § 446(b) (CCH 1991). See BITTKER & LOKKEN, *supra* note 8, ¶ 105.1.4 (discussing IRS's ability to prescribe the method of accounting which clearly reflects a taxpayer's income).

39. If the business purpose test had been applied to recast the debt as equity, there would have been no interest deductions for *Nassau Lens* to accrue. Business income, previously reduced by accruing interest expense, would thus have been fully taxable to the corporation.

40. 397 U.S. 301 (1970).

41. 397 U.S. at 305-07.

tion. A sale of stock ordinarily produces capital gain to the extent that the amount realized exceeds the stock's adjusted basis.⁴² However, the Code provides that the sale form of a redemption is to be respected for tax purposes only if the redemption meets one of the tests specified in code section 302(b).⁴³ Otherwise, the sale form is disregarded and the redemption is taxed as a dividend.⁴⁴ The principal section 302(b) tests are mathematical, requiring that the shareholder's proportionate interests be reduced by specified amounts. However, in addition, section 302(b)(1) provides that a redemption qualifies for sale treatment if, under vague and logically circular language, it is "not essentially equivalent to a dividend."

The precise issue in *Davis* was whether a pro rata redemption (one that did not reduce the shareholder's proportionate interest) was "not essentially equivalent to a dividend" under section 302(b)(1), simply by virtue of the existence of a nontax business purpose.⁴⁵ In other words, the question was whether the nontax business purpose test would determine whether a pro rata redemption was taxed according to its sale form or whether that form would be disregarded and the redemption recast as a dividend.

Marshall construed the language of section 302(b)(1) to refer, not to whether there was a nontax business purpose,⁴⁶ but rather to whether the redemption produced a substantial reduction in the shareholder's proportionate interest:

If a corporation distributes property as a simple dividend, the effect is to transfer the property from the company to its shareholders without a change in the relative economic interests or rights of the stockholders. Where a redemption has that same effect, it cannot be said to have satisfied the "not essentially equivalent to a dividend" requirement of § 302(b)(1). Rather, to qualify for preferred treatment under that section, a redemption must result in a meaningful reduction of the shareholder's proportionate interest in the corporation.⁴⁷

42. I.R.C. § 1001(a) (CCH 1991).

43. *Id.* § 302(a). Sales treatment is granted if: (1) the redemption is "not essentially equivalent to a dividend"; (2) the redemption reduces the shareholder's proportionate interest by more than 20%, applying the attribution of stock ownership rules of section 318; or (3) the redemption terminates the shareholder's stock interest, without the application of the attribution of stock ownership rules of section 318(a)(1). *Id.* § 302(b).

At the time that *Davis* was decided, the rules granting shareholders capital gain treatment as a result of a partial liquidation were contained in a separate provision, section 346, rather than in sections 302(b)(4) and 302(e). *Id.* §§ 302(b)(4), 302(e).

44. *Id.* § 302(d).

45. 397 U.S. at 303-04.

46. *Id.* at 312-13.

47. *Id.* at 313; see also Marvin A. Chirelstein, *Optional Redemptions and Optional Dividends: Taxing the Repurchase of Common Shares*, 78 YALE L.J. 739, 747 (1969). Chirelstein noted:

The "not essentially equivalent [to a dividend]" test of Section 302(b)(1), though not limited in terms to non-pro rata redemptions, is generally thought to subsume the same crite-

Marshall also emphasized, as he had earlier in *Nassau Lens*, the impracticality of the business purpose test:

[M]any courts continued to find that distributions otherwise like a dividend were not “essentially equivalent” if, for example, they were motivated by a sufficiently strong nontax business purpose. . . . There was general disagreement, however, about what would qualify as such a purpose, and the result was a case-by-case determination with each case decided “on the basis of the particular facts of the transaction in question.”⁴⁸

Together, *Nassau Lens* and *Davis* reflect an even-handed approach to tax law, favoring neither taxpayer nor the IRS. It did not matter to Marshall whether the IRS or the taxpayer proposed application of the business purpose test: in *Nassau Lens*, it was the IRS, in *Davis*, the taxpayer. In both cases, he rejected business purpose as irrelevant to determining whether the taxpayer’s form should be respected or recast.

II. CAPITAL GAINS AND LOSSES

Justice Marshall’s 1988 opinion in *Arkansas Best Corp. v. Commissioner*⁴⁹ is the leading Supreme Court case on the subject of capital gains and losses. Marshall used the occasion to eliminate tax avoidance opportunities which had been created thirty-three years earlier by the Supreme Court decision in *Corn Products Refining Co. v. Commissioner*.⁵⁰ Both of these cases deal with two important issues. The first is how to categorize a borderline asset that may not obviously be either capital or noncapital. The second is how to prevent taxpayers from claiming that property is a capital asset when a gain arises but a noncapital asset when there is a loss; that is, how to prevent taxpayers from treating gains and losses inconsistently.

A. THE CORN PRODUCTS PROBLEM

The taxpayer, Corn Products Refining Company (Corn Products), a manufacturer of corn products from raw corn, entered into futures contracts to buy raw corn.⁵¹ Over the years, Corn Products often disposed of the futures

tion and to provide capital gain or loss for non-pro rata distributions which do not meet the specific requirements of Sections 302(b)(2) or 302(b)(3) but which for other reasons seem not to involve the avoidance of ordinary dividend income. Isolated redemptions of part of the company’s preferred stock, or redemptions of common which are pro rata only because stock belonging to one independent or hostile family member is attributed to another, are among the illustrations commonly given of the operation of Section 302(b)(1).

48. *Davis*, 397 U.S. at 309.

49. 485 U.S. 212 (1988).

50. 350 U.S. 46 (1955).

51. *Id.* at 48.

before the delivery date.⁵² Corn Products argued that the futures were capital assets and the gains therefrom were thus taxable at preferential capital gains rates.⁵³ The IRS insisted that the futures were noncapital assets and the gains were thus taxable as ordinary income.

The principal problem is that, *if the futures are treated as capital assets*, Corn Products may be able to treat gains and losses inconsistently. If corn prices rise, Corn Products can dispose of the futures and report the income therefrom as a capital gain. Alternatively, if corn prices fall, Corn Products can take delivery of the raw corn, use it to manufacture corn products and, as illustrated below, effectively treat a capital loss as an ordinary deduction.

Assume that Corn Products enters a contract to purchase a specified amount of raw corn in the future at a price of \$1,000. Corn Products plans to manufacture corn syrup that it has contracted to sell for \$3,000. Suppose that corn prices rise by \$400 to \$1,400, the future is sold for a \$400 gain, and raw corn is purchased in the spot market to meet the manufacturing commitment. If the future is treated as a capital asset, then Corn Products has a \$400 capital gain from selling the future and (ignoring all costs except the cost of raw corn) \$1600 of ordinary income from selling corn syrup.

On the other hand, suppose that shortly before the future delivery date, corn prices fall by \$400 to \$600, and Corn Products takes delivery under the future, paying \$1,000 for raw corn with a current market price of only \$600. When the corn syrup is sold, Corn Products shows ordinary profits from its manufacturing operations of \$2,000. If it had instead disposed of the future and purchased raw corn in the spot market for \$600, it would have had a \$400 capital loss on the future and \$2,400 of ordinary income from selling manufactured products. By taking delivery under the future rather than disposing of it, Corn Products is able to offset the loss on the future against its manufacturing income, effectively converting the capital loss into an ordinary loss.

At this point, some characteristics of the *Corn Products* problem, which can be described as the potential for inconsistent treatment of gains and losses, should be noted. First, the problem arises only because the property which the taxpayer claims as a capital asset is also of a type that can be used in the taxpayer's ordinary business. One can imagine other cases in which there is a similar abuse potential. For example, the steel manufacturer, who invests in a coal mine, could sell the property if coal prices rise but use the coal to manufacture steel if coal prices fall; or the paper manufacturer who invests in forested property, could sell the property if wood prices rise, but use the trees to manufacture paper if wood prices fall.

52. *Id.* at 49 n.5.

53. *Id.* at 49.

Second, as a practical matter, the ordinary investor in corn futures, who does not also use corn as a raw material input in its ordinary business, lacks the opportunity to treat gains and losses inconsistently. For example, Chrysler, an automobile manufacturer, might decide to invest excess funds in corn futures. Since Chrysler's ordinary business, the manufacture of automobiles, does not use corn as a raw material input, there is no potential for Chrysler to take delivery of the corn, use it in its manufacturing process, and thereby achieve inconsistent treatment of gains and losses.

Third, the potential for inconsistent treatment in the *Corn Products* case exists irrespective of Corn Products' motive in acquiring the futures. Corn Products executives testified that the futures were acquired in order to hedge against a rise in the cost of the raw corn used in the company's manufacturing business.⁵⁴ But a "pure" investment purpose is also imaginable. Corn Products might acquire futures simply because it has excess funds not currently required for its manufacturing operations. Rather than use such funds to buy bonds or stocks, Corn Products may decide that it can earn greater investment profits by investing in futures. This is especially likely if Corn Products believes that it possesses more information about the market for corn futures than about other possible investments.

However, even if its motive is to invest, Corn Products retains the ability to take delivery if prices fall, and thereby convert capital losses into ordinary losses. If the investment produces a loss, the taxpayer—because of its position as a corn products manufacturer—could (instead of disposing of the future) take delivery and pay an above-market price for the corn, which it would then use to manufacture corn products. The loss (the difference between the current market price and the price specified in the future) would be reflected in a larger cost of raw material inputs. The taxpayer would show less ordinary income from selling its output, in effect converting the capital loss into an ordinary loss. The taxpayer would not have to dispose of the future and take a capital loss (the difference between the current market price for corn and the price specified in the future), whereas the ordinary investor is unable to avoid capital loss treatment.

Fourth, if the future is classified as a capital asset, the *Corn Products* problem could be resolved provided that taking delivery of the corn under the future is treated as a realization event. Using the numerical example discussed above, if prices fall and Corn Products takes delivery, that would produce realization of a \$400 capital loss. The taxpayer's basis for the raw corn acquired on delivery would be \$600, and ordinary income from manufacturing would be \$2,400, the same as if the future were disposed of at a loss and raw corn purchased in the spot market.

54. *Id.* at 51.

Fifth, realization has never been defined to include performance of a contractual commitment to buy property at a set price. Therefore, a practical way for a court to prevent inconsistent treatment of gains and losses is to resolve the classification question in favor of categorizing the futures as non-capital assets. Then, whether the taxpayer sells the future or takes delivery, all gains and losses are effectively ordinary and the potential for inconsistent treatment is eliminated.

B. THE *CORN PRODUCTS* OPINION

In an opinion by Justice Tom Clark, the Supreme Court held that the corn futures were noncapital assets in the hands of the taxpayer.⁵⁵ However, the principal ground for decision was the taxpayer's motive for entering into the futures contracts, rather than the need to prevent inconsistent treatment of gains and losses.⁵⁶

Justice Clark's analysis conceded that the futures were not property sold to customers in the ordinary course of the taxpayer's business and therefore appeared to qualify as capital assets under the literal language of the Code.⁵⁷ The Court, however, rejected a literal reading of the tax statute.⁵⁸ Congress, the Court reasoned, meant to tax the ordinary, or everyday, profits of a business as ordinary income rather than capital gain.⁵⁹ The taxpayer's ordinary business was to manufacture and sell corn products and the profits therefrom were obviously taxable at ordinary income rates. Since acquisition of the corn futures was integrally connected with that business, gain on the futures was also taxable as ordinary income.

Both the Tax Court and the Court of Appeals found petitioner's futures transactions to be an integral part of its business designed to protect its manufacturing operations against a price increase in its principal raw material and to assure a ready supply for future manufacturing requirements

. . . [I]t is difficult to imagine a program more closely geared to a company's manufacturing enterprise or more important to its successful operation.

. . . .

. . . Congress intended that profits and losses arising from the everyday operation of a business be considered as ordinary income or loss rather than capital gain or loss.⁶⁰

55. *Id.* at 47.

56. *Id.* at 50-51.

57. *Id.* at 51-52.

58. *Id.* at 51 ("Admittedly, petitioner's corn futures do not come within the literal language of the exclusions set out in [the Code].").

59. *Id.* at 52.

60. *Id.* at 50, 52.

Only in the ultimate paragraph of his opinion for the Court, did Justice Clark acknowledge that the facts of *Corn Products* presented a consistency problem, in which the taxpayer might claim capital gains treatment if the futures rose in value but an ordinary loss if the futures showed a loss: “[I]f a sale of the future created a capital transaction while delivery of the commodity under the same future did not, a loophole in the statute would be created”⁶¹

By making the taxpayer’s motive or purpose the critical factor in defining what is a capital asset, rather than focusing on the need to classify borderline assets in a way that will prevent inconsistent treatment of gains and losses, Justice Clark’s opinion inadvertently created the potential for other taxpayers to duplicate the *Corn Products* problem in different circumstances. For example, a newspaper might purchase a paper company’s stock in order to obtain a long-term supply of newsprint from the paper company.⁶² Ordinarily such stock would be considered a capital asset in the hands of the newspaper. But, if the stock fell in value, the newspaper could produce evidence of the business connection and, under *Corn Products*, claim an ordinary loss. On the other hand, if the stock rose in value, the taxpayer could claim a capital gain, and it would ordinarily be difficult for the IRS to know that there was in fact a business motive.

Thus, the rationale of *Corn Products* suffers from the same basic defect as the nontax business purpose test. Rules which rely on a demonstration of taxpayer purpose put the IRS at an enormous disadvantage since such facts are ordinarily within the taxpayer’s control.⁶³

C. ARKANSAS BEST CORP. V. COMMISSIONER

In *Arkansas Best*, the taxpayer, a diversified holding company, acquired nearly two-thirds of the stock of the National Bank of Commerce in 1968.⁶⁴ After 1972, when the bank experienced severe losses, the taxpayer contributed additional capital in return for more stock. In 1975, Arkansas Best sold most of its bank stock at a loss.⁶⁵

The Tax Court conceded that the bank stock appeared to qualify as a capital asset under the literal language of the Code. However, the court found that the taxpayer’s purpose in acquiring stock after 1972 was not to make an investment, but rather to keep the bank from insolvency and thereby pre-

61. *Id.* at 54.

62. See *Booth Newspapers, Inc. v. United States*, 303 F.2d 916 (Ct. Cl. 1962) (stock of paper company acquired by newspaper publisher to assure a supply of newsprint was not acquired for investment purposes and therefore, in hands of taxpayer, is not a capital asset).

63. See *supra* notes 16-18 and accompanying text.

64. *Arkansas Best Corp. v. Commissioner*, 485 U.S. 212 (1988).

65. *Id.* at 213-14.

serve the taxpayer's business reputation.⁶⁶ Therefore, relying on the *Corn Products* business motive test, the court held that the stock acquired after 1972 was a noncapital asset and that the loss on such stock was an ordinary loss.⁶⁷

Justice Marshall, writing for the Supreme Court, affirmed the Eighth Circuit's reversal of the Tax Court. In a stark departure from *Corn Products*, Marshall denigrated the relevance of business purpose or motive as a determining factor in the classification of property as a capital asset:

[T]he business-motive test advocated by petitioner is subject to the same kind of abuse [as] in *Corn Products* The hedger could garner capital-asset treatment by selling the future and purchasing the commodity on the spot market, or ordinary-asset treatment by taking delivery under the future contract. In a similar vein, if capital stock purchased and held for a business purpose is an ordinary asset, whereas the same stock purchased and held with an investment motive is a capital asset, a taxpayer such as Arkansas Best could have significant influence over whether the asset would receive capital or ordinary treatment. Because stock is most naturally viewed as a capital asset, the Internal Revenue Service would be hard pressed to challenge a taxpayer's claim that stock was acquired as an investment, and that a gain arising from the sale of such stock was therefore a capital gain. Indeed, we are unaware of a single decision that has applied the business-motive test so as to require a taxpayer to report a gain from the sale of stock as an ordinary gain. If the same stock is sold at a loss, however, the taxpayer may be able to garner ordinary-loss treatment by emphasizing the business purpose behind the stock's acquisition. The potential for such abuse was evidenced in this case by the fact that as late as 1974, when Arkansas Best still hoped to sell the Bank stock at a profit, Arkansas Best apparently expected to report the gain as a capital gain.⁶⁸

To repeat Marshall's words, "stock is most naturally viewed as a capital asset."⁶⁹ This appears to mean that the bank stock should be classified as a capital asset because it is the treatment which prevents the taxpayer from treating gains and losses inconsistently. However, in *Corn Products*, Marshall noted that the same central concern with preventing inconsistent treatment required the opposite result of classifying the property in question as a noncapital asset.⁷⁰

To summarize, both *Corn Products* and *Arkansas Best* involved arguably borderline assets where the "correct" classification is not self-evident. If the basis for decision is to be whether the property falls within the language of

66. *Id.* at 214-15.

67. *Id.* at 215.

68. *Id.* at 222-23.

69. *Id.* at 222.

70. *Id.* at 222.

the section 1221 exclusions, then reasonable arguments could be made either for or against capital asset classification. Comparing the two cases, Marshall seems to suggest that classifying the assets "correctly" may be less important than preventing taxpayers from treating gains and losses inconsistently. He rejects the *Corn Products* motive test which relies on facts uniquely within the taxpayer's control and widens the opportunity for claiming a capital gain if the property increases in value but an ordinary loss if it falls in value. Instead, he argues for adopting the classification in each case which better prevents inconsistent treatment of gains and losses.⁷¹

71. The Supreme Court's opinion in *Arkansas Best* has been unfairly criticized for creating uncertainty and confusion concerning the treatment of certain currency and interest rate hedges. See Kenneth P. Brewer, "*Best*" Facts Make Bad Law, 39 TAX NOTES 403, 403 (1988); Alan W. Cathcart, *Effect of Arkansas Best on Foreign Currency Transactions*, 39 TAX NOTES 397, 398 (1988); Kathleen Matthews, *Treatment of Liability, Foreign Currency Hedges Awaits Resolution*, 40 TAX NOTES 778, 778 (1988).

To illustrate, a manufacturer may contract to be paid for its inventory in a foreign currency rather than in dollars. In order to be certain of earning a fixed U.S. dollar amount regardless of fluctuations in international exchange rates, the manufacturer may then decide to enter a foreign currency hedge. Or a company may commit itself to lend money at an interest rate to be determined at some future date. In order to lock in a fixed return, the company may enter an interest rate hedge. Before *Arkansas Best* was decided, such hedges were treated as producing ordinary income and losses because of their connection with the taxpayer's business and therefore fell under the *Corn Products* doctrine.

Arkansas Best reinterpreted *Corn Products* as restricted to hedges in a taxpayer's inventory. Because the corn futures in that case could be viewed as substitutes for, or the equivalent of, raw corn, Marshall wrote that they should be treated exactly the same as raw corn, which would have been considered part of the taxpayer's inventory and therefore excluded from capital asset treatment by Code section 1221(2). *Arkansas Best Corp. v. Commissioner*, 485 U.S. 212, 421 (1988). The inventory exclusion obviously cannot encompass foreign currency or interest rate hedges, and so taxpayers claimed that they were left uncertain about whether to treat such hedges as capital or noncapital assets.

Nevertheless, both currency and interest rate hedges described above could easily fit within other exceptions to capital asset treatment. The currency hedge can be viewed as falling within the section 1221(4) exclusion for accounts receivable for inventory. The manufacturer's accrued right to be paid for selling its inventory is an account receivable. The currency hedge, designed to ensure that the account receivable reflects a fixed dollar amount, can be viewed as a substitute for, or equivalent to, the account receivable—in the same way that the corn future in *Corn Products* can be viewed as a substitute for, or equivalent to, raw corn.

Similarly, the interest rate hedge can be viewed as a substitute for interest income and therefore treated under well established principles as producing ordinary income or loss rather than as a capital transaction. See, e.g., *United States v. Midland-Ross Corp.*, 381 U.S. 54 (1965) (earned original issue discount not entitled to capital gains treatment); Lee A. Sheppard, *Liability Hedging After Arkansas Best*, 46 TAX NOTES 634, 635-36 (1990).

To the extent that confusion and uncertainty followed *Arkansas Best*, the responsibility appears to lie, if at all, with the Internal Revenue Service. Following the *Arkansas Best* case, the IRS might have provided technical advice that currency and interest rate hedges would be viewed as producing ordinary gain or loss for the reasons explained above. However, the IRS declined to act. See Lee A. Sheppard, *Waiting for Guidance on Business Hedges After Arkansas Best? Don't Hold Your Breath, Says Hood*, 49 TAX NOTES 139, 140 (1990).

The IRS may have been reluctant to take such a step because, as a result of Marshall's opinion in *Arkansas Best*, it noticed for the first time that such hedges could result in inconsistent treatment of

III. REALIZATION

The realization principle—that gains and losses on property are accounted for only when the property is sold or exchanged—is basic to our federal income tax system.⁷² During the first three decades of the modern income tax, the Court, on repeated occasions, grappled with the issue of what constitutes realization.⁷³ Then, after 1947, with its essential meaning taken for granted, realization as a legal issue for the Court dropped out of sight.⁷⁴

Marshall's 1991 opinion in *Cottage Savings Ass'n v. Commissioner*⁷⁵ was the first occasion in forty-four years on which the Court considered the meaning of realization. The case had serious implications for the administration of the federal income tax. The IRS was asking the court to radically reinterpret the meaning of realization.⁷⁶ The IRS argued that an exchange of different properties should not produce realization if the properties had nearly identical expected risk and return. It proposed the new interpretation in order to curb what it believed to be a particular abuse.⁷⁷

However, this proposed interpretation depended in part on taxpayer purpose.⁷⁸ Furthermore, even aside from its reliance on purpose, the interpretation lacked discernible, and therefore administrable, boundaries.⁷⁹ If the interpretation had been accepted, it could have confused an already complex

gains and losses. If the hedge produced a gain, the taxpayer could dispose of the hedge and claim to have simply made an investment. If the hedge produced a loss, the taxpayer would disclose the connection between the currency hedge and selling inventory or between the interest hedge and lending money and claim an ordinary deduction.

The best solution to resolving this inconsistency problem might be for the IRS to recommend that the Code be amended to require taxpayers to label such hedges as either capital or noncapital when entered. Clear advance labeling would then prevent taxpayers from claiming either capital or ordinary treatment after the fact, depending on whether the hedge showed a gain or loss. Cf. I.R.C. § 1236 (CCH 1991) (permitting a dealer in securities to hold some securities as investments provided they are clearly labeled as such).

72. See, e.g., BITTKER & LOKKEN, *supra* note 8, § 5.2 at 5-17 ("realization is so basic to the structure of the [tax] law that the principle is not challenged").

73. See, e.g., *Helvering v. Sproule*, 318 U.S. 604 (1943); *Helvering v. Horst*, 311 U.S. 112 (1940); *Helvering v. Bruun*, 309 U.S. 461 (1940); *Koshland v. Helvering*, 298 U.S. 441 (1936); *Marr v. United States*, 268 U.S. 536 (1925); *Weiss v. Stearn*, 265 U.S. 242 (1924); *Eisner v. Macomber*, 252 U.S. 189 (1920).

74. The last case before 1991 in which realization was even implicitly an issue was *McWilliams v. Commissioner*, 331 U.S. 694 (1947). For a discussion of *McWilliams*, see *infra* Part III.A.

75. 111 S. Ct. 1503 (1991).

76. *Id.* at 1507 (Commissioner argued that requirement of a material difference in exchanged properties precluded realization when exchange involved "essentially economic substitutes").

77. *Id.* at 1506-07 (under federal regulatory directive, savings and loans, for financial reporting purposes, need not report losses on mortgages exchanged for "substantially identical" mortgages, even though exchanges would generate tax losses).

78. *Id.* at 1509 (Commissioner argued that material difference in properties should be determined, in part, by "the attitudes of the parties").

79. *Id.* at 1510 (Commissioner's approach at odds with "goal of administrative convenience that underlies the realization requirement").

area of tax law. In addition, there is some question as to whether the problem in the case was an abuse of the tax system or rather an abuse of nontax financial accounting.

Marshall, therefore, wisely rejected the new interpretation of the realization requirement proposed by the IRS.⁸⁰ Since Marshall was building on a foundation created some decades earlier by the Supreme Court decisions in *Higgins v. Smith*⁸¹ and *McWilliams v. Commissioner*,⁸² those two cases will be discussed first.

A. *HIGGINS V. SMITH* AND *MCWILLIAMS V. COMMISSIONER*

In *Higgins v. Smith*, the taxpayer (Smith) sold securities at a loss to his wholly-owned corporation. The issue was whether the property had been sold so that the loss was realized and therefore deductible by Smith.⁸³ Writing for the Court in 1940, Justice Stanley F. Reed held that there was a sale only in form and not in substance, since a corporation which the taxpayer controlled continued to own the securities:

Title, we shall assume, passed to [the corporation] but the taxpayer retained the control. Through the corporate forms he might manipulate as he chose the exercise of shareholder's rights in the various corporations, issuers of the securities, and command disposition of the securities themselves. There is not enough of substance in such a sale finally to determine a loss.

. . . .
. . . [T]he Government may not be required to acquiesce in the taxpayer's election of that form for doing business which is most advantageous to him. The Government may look at actualities and upon determination that the form employed for doing business or carrying out the challenged tax event is unreal or a sham may . . . disregard the effect of the fiction. . . . It is command of income and its benefits which marks the real owner of property.⁸⁴

Thus, *Higgins v. Smith* stands for the proposition that when a taxpayer sells property to a controlled or related party at a loss, there is not enough of a sale in substance, and the loss may not be deducted since the taxpayer may continue to exercise dominion over the property and effectively continue to own it.

Seven years after *Higgins v. Smith*, in 1947, the Court considered an analo-

80. *Id.* at 1509-11.

81. 308 U.S. 473 (1940).

82. 331 U.S. 694 (1947).

83. *Smith*, 308 U.S. at 474-75.

84. *Id.* at 476-78.

gous problem in *McWilliams v. Commissioner*.⁸⁵ The taxpayer sold shares of stock and his spouse bought the same number and kind of shares. Both transactions occurred almost simultaneously on the open market. The issue again was whether a real sale had occurred so that the loss was deductible.⁸⁶ Had the taxpayer simply sold the stock to his spouse, there would have been no question that the loss was not deductible, either under the principle of *Higgins v. Smith*, or under the statutory codification of that principle in the antecedent of current section 267 of the Code, which disallows losses on the sale of property between related parties.⁸⁷

The chief difference with the facts of *Higgins v. Smith* was that *McWilliams* did not sell his stock to his spouse, and his spouse did not buy her stock from him. Rather, each bought and purchased shares on the open market.⁸⁸ Thus, the precise shares sold by the taxpayer were not the precise shares purchased by the taxpayer's spouse. The spouse had merely purchased the same number and kind of shares in the same company. However, because the property sold and acquired by the related parties was fungible, the Court treated the case as if the spouse had in fact purchased the exact same property from the taxpayer.⁸⁹ Therefore, the Court held that in effect there had been a sale to an unrelated buyer only in form, not in substance, and that the husband's loss could not be deducted.⁹⁰

Higgins v. Smith and *McWilliams* were the Supreme Court precedents most directly on point when *Cottage Savings* reached the Court. Under *Higgins v. Smith*, no loss was deductible when the taxpayer sold property to a controlled or related party. Under *McWilliams*, the same result applied when the taxpayer sold and his spouse simultaneously acquired fungible property.

B. COTTAGE SAVINGS ASS'N V. COMMISSIONER

The taxpayer, Cottage Savings, was a federally regulated savings and loan institution. Cottage Savings held a portfolio of home mortgage loans that had fallen in value when interest rates rose dramatically during the late 1970s. Pursuant to a Federal Home Loan Bank Board (FHLBB) regulatory directive regarding exchanges of substantially identical mortgages with other lenders, Cottage Savings exchanged its existing mortgage portfolio for a new portfolio of different mortgages with virtually identical risk and expected re-

85. 331 U.S. 694 (1947).

86. *Id.* at 695-96.

87. I.R.C. § 267 (CCH 1991).

88. 331 U.S. at 695.

89. *Id.* at 698-99.

90. *Id.* at 700-01.

turn characteristics.⁹¹ The issue was whether the exchange qualified as a realization in substance, permitting deduction of the loss.⁹²

The IRS argued that, because there was no change in the underlying economic position of Cottage Savings, there was no realization in substance.⁹³ This argument involved a dramatic modification and expansion of previous interpretations of what constitutes a mere realization in form without a realization in substance. Unlike the taxpayer in *Higgins v. Smith*, Cottage Savings did not retain control or command over the specific property that it sold or exchanged.⁹⁴ Nor were the two mortgage portfolios—the one traded and the one received—fungible in the same sense as the properties in *McWilliams*. The stock sold by McWilliams and the stock purchased by his spouse involved the same kind of shares in the same company. In *Cottage Savings*, the mortgages, although sharing virtually identical economic characteristics, did have different obligors and were secured by different properties.⁹⁵ It was as if the stock sold and purchased by the McWilliamses involved different companies, with different specific assets and liabilities, but with the same risk and expected return and conducting the same type of business.

The IRS believed that its new interpretation of realization was justified by the taxpayer's inconsistent treatment of the loss. Cottage Savings claimed that the loss was realized and therefore was deductible for federal income tax purposes. At the same time, the taxpayer treated the loss as not realized and therefore not reportable for financial accounting purposes.⁹⁶

The FHLBB, the entity responsible for financial regulation of the savings and loan industry, had encouraged Cottage Savings's actions. The FHLBB used its regulatory authority to provide that losses from mortgage swap transactions—which it believed would be deductible for federal tax purposes—would not have to be realized for financial reporting purposes. The FHLBB's only objective in promoting the mortgage swaps was to enable Cottage Savings (and other savings and loans) to report a tax loss without recording the loss on its balance sheet.⁹⁷ This would provide significant cash

91. *Cottage Sav.*, 111 S. Ct. at 1506.

92. *Id.* at 1507-08. Code section 1001(a) defines "[t]he gain [or loss] from the sale or other disposition of property" as the difference between "the amount realized" and the "adjusted basis." I.R.C. § 1001(a) (CCH 1991). Under Treasury Regulation 1.1001-1, a gain or loss is considered realized on an exchange of property only if the properties exchanged are "different materially either in kind or in extent." Treas. Reg. § 1.1001-1 (1972). Thus, the precise issue in *Cottage Savings* was whether the exchanged mortgages were materially different under the regulation.

93. *Cottage Sav.*, 111 S. Ct. at 1507.

94. Each party to the exchange continued to service the loans which it had exchanged. *Id.* at 1506 n.3. The Commissioner did not contend that this activity constituted a retention of control over the property.

95. *Id.* at 1511.

96. *Id.* at 1506-07.

97. *Id.* at 1506. In a memorandum describing the mortgage swaps transactions, an FHLBB

benefits to financially strapped savings and loans in the form of tax refunds without adverse balance sheet consequences, which could otherwise require the savings and loan's closure.⁹⁸

Finding for the taxpayer, Marshall held that the loss on the mortgage portfolio was realized because the new portfolio conferred "legally distinct entitlements."⁹⁹ He rejected the IRS's position that realization does not occur on an exchange of nonfungible properties with the same economic characteristics.¹⁰⁰

Marshall also noted practical difficulties with the IRS position. If the exchanged properties are not fungible, how does one determine whether they have the same economic characteristics? Which economic characteristics are relevant? Further, how does one determine whether the properties, with respect to the relevant characteristics, are sufficiently alike?

The IRS suggested that it would examine how the parties regarded the transaction.¹⁰¹ In *Cottage Savings*, if the parties to the transaction, the FHLBB, and the secondary mortgage market regarded the two mortgage portfolios as economically identical, then they should also be treated as identical for federal income tax purposes.¹⁰² Marshall predictably objected to what he termed "such a subjective test":

In order to apply the Commissioner's test in a principled fashion, the Commissioner and the taxpayer must identify the relevant market, establish whether there is a regulatory agency whose views should be taken into account, and then assess how the relevant market participants and the agency would view the transaction. The Commissioner's failure to explain how these inquiries should be conducted further calls into question the workability of his test.¹⁰³

Of course, applying the test proffered by the IRS to the facts of *Cottage Savings* would not have been a problem. The taxpayer had openly claimed that the swapped mortgages had identical economic characteristics. The FHLBB in fact required such a claim in order for the taxpayer to avoid reporting the losses for purposes of nontax financial accounting. On the other

official stated: "Our objective . . . was to structure a transaction which was as close as possible to the IRS 'materially different' definition which would still not change the economic position of the association after it engaged in the swap." *Cottage Sav. Ass'n v. Commissioner*, 90 T.C. 372, 376 (1988), *rev'd*, 890 F.2d 848 (6th Cir. 1989), *rev'd*, 111 S. Ct. 1503 (1991).

98. 111 S. Ct. at 1506. Ordinarily, under generally accepted accounting principles, losses realized on exchanges of properties—even fungibles—must be reported. However, reporting would have rendered many savings and loans insolvent and, therefore, required that the FHLBB shut them down. *Id.*

99. *Id.* at 1511.

100. *Id.* at 1510.

101. *Id.* at 1509-10.

102. *Id.* at 1511.

103. *Id.* at 1510-11.

hand, accepting the IRS test and restricting its application to similar transactions would treat Cottage Savings (and other savings and loans) inconsistently and arbitrarily compared to taxpayers whose situations would not require such an admission.

Even aside from questions of practicality, our tax law has consistently treated losses as realized even if the taxpayer replaces the property sold with other property with nearly identical economic characteristics. For example, an investor might sell stock that has fallen in value and immediately acquire a different stock with essentially the same risk and return characteristics. Or an investor in land that has fallen in value might sell the land and promptly acquire other land of a similar type and location. In both cases, provided that the property is sold in substance as well as in form so that command or control over it is surrendered, and so long as the new property is not *fungible* with respect to the property sold, then the losses may be deducted.¹⁰⁴

Obviously, realization could be defined very differently. One can imagine a tax system under which the replacement of property with other property with identical economic characteristics is generally not considered an appropriate occasion for taking losses into account. Nevertheless, our tax law has consistently treated such losses as realized. A fundamental revision of the definition of realization should therefore be made by Congress amending the Code, rather than by unilateral IRS action.

Cottage Savings does involve an egregious abuse of accounting practices. Generally accepted accounting principles universally require losses on property to be reported no later than when the property is sold or exchanged. For the FHLBB to encourage institutions to conceal realized losses for financial reporting purposes was grossly irresponsible.¹⁰⁵ Nevertheless, it is difficult to see why the FHLBB's abuse of its regulatory authority in the area of financial reporting should mean that Cottage Savings and other savings and

104. An earlier Court of Appeals decision on this issue noted that the Commissioner's position would radically alter notions of what constitutes realization:

Exchanges of items which were clearly different would not necessarily constitute realization events. For example, if two taxpayers exchanged two bonds of different corporate entities engaged in entirely different businesses, but which have the same rating by Moody's, the same interest rate, the same cash flow, the same maturity and the same value in the capital market then no change in their "economic status" would have occurred.

San Antonio Sav. Ass'n v. Commissioner, 887 F.2d 577, 590 (5th Cir. 1989).

105. In fact, where the public has an interest in knowing whether an enterprise faces insolvency, prudent accounting would require the disclosure even of unrealized losses. Thus, the FHLBB probably should have required the savings and loan institutions to disclose large unrealized losses on their mortgage portfolios in order to protect public depositors. Its failure to require reporting of such unrealized losses is questionable enough. To authorize the nondisclosure of losses that have actually been realized was blatant dishonesty that helped conceal the festering savings and loan debacle.

loans may not take an allowable tax deduction. Recognizing this, Justice Marshall quite properly found for the taxpayers in this case.

IV. CHARITABLE CONTRIBUTIONS

Marshall's work in the charitable contribution area is paradoxical. His most important opinion and the leading case, *Hernandez v. Commissioner*,¹⁰⁶ involved the intersection of the tax law and constitutional rights. Marshall, generally regarded as a guardian of civil rights and constitutional liberties, but not often regarded as a tax lawyer, seems to have gotten the tax part right but the constitutional part wrong. While correctly analyzing the principles governing the tax issues, he was surprisingly insensitive to the possible violation of constitutional rights.

There were two principle questions in *Hernandez*: whether expenditures by members of the Church of Scientology were charitable contributions or personal consumption; and whether denial of a deduction for such expenditures discriminated against the Church of Scientology. Since Marshall's opinion relied on earlier decisions distinguishing charitable contributions from personal consumption, including his own opinion in *United States v. American Bar Endowment*,¹⁰⁷ this preexisting body of law deserves brief examination.

A. DEFINING CHARITY

The Code requires that, in order for the taxpayer to claim a deduction, a charitable contribution must go to an organization that qualifies for tax-exempt status under section 501(c)(3).¹⁰⁸ But the Code does not further define the term "charitable contribution." Long before Marshall's opinions in *American Bar Endowment* and *Hernandez*, the IRS had ruled, and lower courts had consistently held, that such contributions are deductible only to the extent that the taxpayer does not receive in return a quid pro quo consisting of valuable goods or services.¹⁰⁹

In practice, however, this quid pro quo rule is widely violated, and IRS

106. 490 U.S. 680 (1989).

107. 477 U.S. 105 (1986).

108. Code section 170(c)(2) includes organizations "operated exclusively for religious, charitable, scientific, literary, or educational purposes, or to foster national or international amateur sports competition . . . or for the prevention of cruelty to children or animals[,] no part of the net earnings of which inures to the benefit of any private shareholder or individual . . ." I.R.C. § 170(c)(2) (CCH 1991). This list is substantially that of section 501(c)(3) organizations.

109. In Rev. Rul. 67-246, 1967-2 C.B. 104, the IRS stated that a charitable contribution is deductible only to the extent that it exceeds the market value of any benefit received in return. Cited with approval in *Oppewal v. Commissioner*, 468 F.2d 1000, 1002 (1st Cir. 1972); *Singer Co. v. United States*, 449 F.2d 413, 422, 424 (Ct. Cl. 1971); *Murphy v. Commissioner*, 54 T.C. 249 (1970).

enforcement has been discouragingly ineffective.¹¹⁰ In general, charities inform donors that their contributions are deductible "to the extent permitted by law."¹¹¹ The donor is left to figure out the hidden meaning of "extent permitted," that is, that the contribution may be deducted only to the extent that it exceeds the value of goods and services received in return.

Complicating matters further, the IRS explicitly recognizes an exception to the quid pro quo rule when the contribution is made to a religious institution and the quid pro quo consists of religious benefits.¹¹² For example, church and synagogue members are permitted to deduct the full amount of membership dues, including pew rents and tickets which entitle members to particular seats during religious services, *entirely without regard to the value of the benefits received in return.*¹¹³

This recognized exception to the quid pro quo rule has been justified by a doubtful assertion: religious services do not provide significant economic benefits to the donor.

[R]eligious observances generally are not regarded as yielding private benefits to the donor, who is viewed as recognizing only incidental benefits when attending the observances. The primary beneficiaries are viewed as being the general public and members of the faith. Thus, payments for saying masses, pew rents, tithes, and other payments involving fixed donations for similar religious services are fully deductible contributions.¹¹⁴

What justifies the claim that pew rents and high holiday tickets sold by churches and synagogues necessarily fail to provide significant economic benefits to the donor as compared with tickets to a museum or a symphony

110. See, e.g., *Deductible to the Extent Permitted By Law*, 38 TAX NOTES 1557, 1557 (1988) (author anonymous) (calling for end to allowing deduction of charitable contributions when contributions are given in exchange for tickets to benefit dinners, benefit auctions, and free lectures).

111. *Id.* at 1557. For the latest IRS attempt to achieve better compliance, see Rev. Proc. 90-12, 1990-1 C.B. 471 (providing guidelines explaining when an item given in exchange for contribution will be deemed to have no fair market value so that charities can advise taxpayers to what extent their contributions are deductible).

112. A.R.M. 2, 1 C.B. 150 (1919) (pew rents, assessments, and church dues are contributions and not the hiring of a seat for personal accommodation, because their real intent is contributory); Rev. Rul. 70-74, 1970-1 C.B. 49; cf. Rev. Rul. 71-580, 1971-2 C.B. 235 (church which compiles genealogical information of members in order to conduct religious ordinances in accordance with church doctrine, as well as the saying of mass or conduct of similar religious observances, is providing a spiritual benefit to all members of the faith, so that any benefit to the family is incidental; the church is therefore accomplishing a charitable purposes and qualifies for the tax-exempt status).

113. Rev. Rul. 70-74, 1970-1 C.B. 49.

114. *IRS Official Explains New Examination-Education Program on Charitable Contributions to Tax Exempt Organizations*, Daily Tax Rep. (BNA) No. 186, at J-1 (Sept. 26, 1988); see also *Staples v. Commissioner*, 821 F.2d 1324, 1326 (8th Cir. 1987) (religious observances considered to be of spiritual benefit to general public as well as members of the faith, with the private benefit to individual participants being merely incidental to the broader good that is served); *id.* ("cases and legislative history in discussing payments which are not deductible generally have referred to a material, financial, or economic benefit being received in return").

orchestra?¹¹⁵ The only meaningful indicator of economic value is whether people are in fact willing to pay for the service. If individuals are prepared to pay, then the service appears to provide a significant economic benefit, whether labeled religious or not. The absence of economic benefit cannot be demonstrated by reference to some external criterion which describes the cultural context in which the service is provided, such as the fact that the service is religious.

There is an extraordinarily difficult problem in this area, but it is essentially an administrative one which is not limited to religious services. It is the problem of assigning a fair market value to a quid pro quo or return benefit, received in the context of a charitable contribution. Such a value must be ascertained in order to determine how much of the contribution is deductible.

When the quid pro quo consists of items that are generally provided to the public on the open market in a noncharitable commercial context, then ascertaining the fair market value is relatively simple. Such value equals the price generally charged in the open market for the item. However, valuation difficulties arise when there is no such market reference because the item is not generally available except from a charity. For example, the kinds of special services provided to sponsors of tax-exempt symphony orchestras and ballets—such as attendance at rehearsals and priority in buying tickets—are not generally sold in a noncharitable, commercial context. Similarly, religious services provided to church and synagogue members are not ordinarily sold in a noncharitable, commercial context.

In both of these cases, the IRS faces the difficulty of assigning a fair market value to the quid pro quo in the absence of an obvious market benchmark. But this valuation problem is inherently no greater in the case of religious institutions than in the case of the orchestra or the ballet. Therefore, the difficulty of valuing return benefits does not by itself justify an exception to the quid pro quo rule which automatically regards all religious services as providing zero economic benefit to the donor.

There may exist, however, constitutional reasons for creating such an exception to the quid pro quo rule. The petitioner in *Hernandez* argued:

The . . . suggestion—that religious services may be valued by reference to “the price set by providers of similar services”—is . . . unconstitutional. . . .

115. This claim cannot be justified on the ground that individuals may obtain the religious services in question without having to pay for them. Attendance at many high holiday services, for example, is typically restricted to ticket holders. Those who do not pay for tickets are denied entrance and may not attend. Brief for the Petitioners at 23, *Hernandez v. Commissioner*, 490 U.S. 680 (1989) (No. 87-963). In addition, Mormons who fail to tithe are denied access to the Tabernacle. Corporation of the Presiding Bishop of the Church of Jesus Christ of Latter-Day Saints v. Amos, 483 U.S. 327, 330 n.4 (1987); Petitioners Brief at 21, *Hernandez* (No. 87-963).

[T]he very notion of comparing relative values of religious services impermissibly entangles church and state both through the valuation of religious services and through the creation of denominational preferences. Finally, valuing services based on the "costs of providing the services," also would create constitutional difficulties. Determining the cost of providing services would require deep intrusions into a church's finances and operations, creating excessive and unconstitutional church-state entanglement.¹¹⁶

Thus, the religious services exception to the quid pro quo rule may avoid excessive government entanglement in religious affairs which could arise if valuation of religious practice were an issue. This constitutional argument provides a much more solid ground for the religious services exception to the quid pro quo rule than the doubtful assertion that such services do not provide the donor with economic benefits.

B. UNITED STATES V. AMERICAN BAR ENDOWMENT

The Supreme Court first directly considered the quid pro quo rule in *United States v. American Bar Endowment*.¹¹⁷ American Bar Endowment (ABE) is a section 501(c)(3) organization which promotes legal research. All members of the American Bar Association are also automatically members of ABE.¹¹⁸

ABE sold life, health, and medical insurance to its members and contracted with private insurance companies to provide the actual coverage.¹¹⁹ The rates that ABE charged its members for insurance were equivalent to rates charged by commercial insurance companies.¹²⁰ However, ABE was able to pay private insurance companies much less than it charged its individual members because of its superior bargaining power and because the group took advantage of the membership's lower than average mortality and morbidity rates.¹²¹ ABE used funds generated by the difference between the rates it charged its members and the cost of policies to finance its research program.¹²² One issue the Court faced was whether ABE members could deduct, as a charitable contribution, the difference between their cost of insurance and the actual cost to ABE.¹²³

In his opinion for the Court, Marshall ruled that the difference was not deductible.¹²⁴ Since ABE charged the same rates as commercial insurance

116. Petitioners Brief at 40 n.55, *Hernandez* (No. 87-963) (citations omitted).

117. 477 U.S. 105 (1986).

118. *Id.* at 107.

119. *Id.*

120. *Id.* at 108.

121. *Id.* at 107-08.

122. *Id.* at 108.

123. *Id.* at 106-07, 109.

124. *Id.* at 119.

companies, ABE members received a quid pro quo equal to the full extent of what they paid.¹²⁵ Therefore, there was no excess of the amount paid over the value of the benefit received that would constitute a deductible charitable contribution.¹²⁶

C. *HERNANDEZ V. COMMISSIONER*

Instead of conventional religious services, the Church of Scientology (Church) uses “auditing” and “training” sessions to develop its members’ spiritual awareness.¹²⁷ The principle issue in *Hernandez* was whether the taxpayers, members of the Church, were entitled to deduct as charitable contributions payments made to the Church for their participation in these sessions.¹²⁸

As in *American Bar Endowment*, Marshall construed the Code as permitting a charitable contribution deduction only to the extent that taxpayers do not receive an economic benefit in return for their contribution.¹²⁹ Marshall explicitly rejected the taxpayers’ claim that the quid pro quo or return benefit analysis has no place when there is a payment for the right to participate in a religious service:

[I]t finds no support in the language of [the Code] Congress has specified that a payment to an organization operated exclusively for religious (or other eleemosynary) purposes is deductible *only* if such a payment is a “contribution or gift.” The Code makes no special preference for payments made in the expectation of gaining religious benefits or access to a religious service.¹³⁰

Having rejected the idea of an exception to the quid pro quo rule for religious benefits, Marshall failed to address the argument forcefully made by petitioner that determining what portion of the donation represents the “value” of the religious exercise being purchased and what portion represents a contribution might entangle the government in religious affairs.¹³¹ He re-

125. *Id.* at 118.

126. *Id.* at 116, 118.

127. 490 U.S. at 685.

128. *Id.* at 684.

129. *Id.* at 690-91.

130. *Id.* at 692-93 (citations omitted).

131. This omission may be explained by the multitude of facts which could have been taken to show there was no payment in excess of the value of the benefits received in the particular case of *Hernandez*.

As the Tax Court found, these payments were part of a quintessential *quid pro quo* exchange: in return for their money, petitioners received an identifiable benefit, namely, auditing and training sessions. The Church established fixed price schedules for [these] sessions . . . it calibrated particular prices to . . . sessions of particular lengths and levels of sophistication; it returned a refund if auditing and training services went unperformed; it distributed “account cards” on which persons who had paid money to the Church could

ferred only to the entanglement problems that an exception to the quid pro quo rule for religious services might create:

Finally, the deduction petitioners seek might raise problems of entanglement between church and state. If framed as a deduction for those payments generating benefits of a religious nature for the payor, petitioners' proposal would inexorably force the IRS and reviewing courts to differentiate "religious" benefits from "secular" ones. If framed as a deduction for those payments made in connection with a religious service, petitioners' proposal would force the IRS and the judiciary into differentiating "religious" services from "secular" ones. . . . [W]e do note that "pervasive monitoring" for "the subtle or overt presence of religious matter" is a central danger against which we have held the Establishment Clause guards.¹³²

Also troubling was Marshall's refusal to consider the petitioners' claim that the IRS had discriminated against the Church of Scientology. To support the discrimination claim (made only on appeal) the taxpayers placed in the record copies of IRS Revenue Rulings that allowed a charitable contribution deduction for payments for pew rents and high holiday tickets.¹³³ Marshall, who was a stickler for procedural technicalities,¹³⁴ held that this record was not sufficient to demonstrate that the IRS had in fact permitted followers of more conventional religious faiths to deduct in full payments for religious services without application of the quid pro quo rule:

Perhaps because the theory of [discrimination] emerged only on appeal, petitioners did not endeavor at trial to adduce from the IRS or other sources any specific evidence about other religious faiths' transactions. The IRS' revenue rulings, which merely state the agency's conclusions as to deductibility and which have apparently never been reviewed by the Tax Court or any other judicial body, also provide no specific facts about the nature of these other faiths' transactions. In the absence of such facts, we simply have no way (other than the wholly illegitimate one of relying on our personal experiences and observations) to appraise accurately whether the IRS' revenue rulings have correctly applied a *quid pro quo* analysis with respect to any or all of the religious practices in question. We do not know, for example, whether payments for other faiths' services are truly obliga-

monitor what prepaid services they had not yet claimed; and it categorically barred provision of . . . sessions for free. Each of these practices reveals the inherently reciprocal nature of the exchange.

Id. at 691-92 (footnote omitted).

132. *Id.* at 694 (citation omitted). The entanglement test used in *Hernandez* has been called into question. See, e.g., *Lee v. Weisman*, 112 S. Ct. 2649, 2661 (1992) (religious prayer at public school graduation ceremony violated Establishment Clause).

133. *Hernandez*, 490 U.S. at 701.

134. See, e.g., Randall Kennedy & Martha Minow, *Thurgood Marshall and Procedural Law: Lawyers' Lawyer, Judge's Judge*, 6 HARV. BLACKLETTER J. 95, 97-100 (1989) (speculating as to the causes of Marshall's commitment to precision in procedural matters).

tory or whether any or all of these services are generally provided whether or not the encouraged "mandatory" payment is made.¹³⁵

Justice O'Connor's dissent took the view that the discrimination issue had been posed:

[The Court] has chosen to ignore both longstanding, clearly articulated IRS practice, and the failure of [the government] to offer any cogent, neutral explanation for the IRS' refusal to apply this practice to the Church of Scientology. Instead, the Court has pretended that whatever errors in application the IRS has committed are hidden from its gaze In my view, the IRS has misapplied its longstanding practice of allowing charitable contributions . . . in a way that violates the Establishment Clause. It has unconstitutionally refused to allow payments for the religious service [of Scientology] to be deducted as charitable contributions in the same way it has allowed fixed payments to other religions to be deducted.¹³⁶

There is a possible explanation for Marshall's decision not to consider the issue of unconstitutional discrimination. Charitable contributions are deductible to begin with only if the recipient organization qualifies as tax-exempt under Code Section 501(c)(3).¹³⁷ In previous litigation, the Court of Appeals for the Ninth Circuit found that leaders of the Church had diverted church funds for their own use and that therefore the Church's principal branch, located in California, did not qualify as a section 501(c)(3) organization.¹³⁸ Thus, contributions to the California branch were not made to a qualified section 501(c)(3) organization and were therefore not deductible.

That decision did not affect the tax-exempt status of other church branches, including the branch which received payments from the taxpayer in *Hernandez*.¹³⁹ For purposes of *Hernandez*, the IRS had stipulated that the Scientology Church branch did qualify as a section 501(c)(3) organization.¹⁴⁰ In effect, the government, for mysterious reasons had all but stipulated away its case. The stipulation barred the Court from explicitly considering a more plausible ground for denying deduction of the contributions in *Hernandez*, namely that the Scientology Church branch in this case also failed to qualify as a section 501(c)(3) organization. Marshall, however, certainly knew of the decision with respect to the California branch of the Church.¹⁴¹ As a result, he may not have regarded the Church as a bona fide section 501(c)(3) organization.

135. *Hernandez*, 490 U.S. at 702.

136. *Id.* at 713 (O'Connor, J., dissenting).

137. *See supra* note 108 and accompanying text.

138. *Church of Scientology v. Commissioner*, 823 F.2d 1310, 1315-19 (9th Cir. 1987), *cert. denied*, 486 U.S. 1015 (1988).

139. 490 U.S. at 686 & n.4.

140. *Id.* at 686.

141. Marshall cited *Church of Scientology*, 823 F.2d 1310, in *Hernandez*. *Id.* at 686 n.4.

In sum, while Marshall may be open to criticism for his handling of the constitutional issues in *Hernandez*, his treatment of the tax question was commendable. He affirmed the general rule that charitable contributions are deductible only to the extent that the payment exceeds the value of benefits received. Moreover, he properly rejected the conventional wisdom that religious benefits inherently lack economic value. *Hernandez* is a useful and long overdue admonition to the IRS: enforce the general quid pro quo rule with more consistency and rigor and reexamine whether payments to churches and synagogues for bona fide religious services should always be treated as fully deductible charitable contributions, without regard to application of the quid pro quo rule.

CONCLUSION

Specialists in federal income taxation who reviewed this article generally agreed with its conclusions about the importance of Marshall's work. However, specialists whose field is the Supreme Court have reacted somewhat differently.

One reaction has been to attribute the number of significant tax opinions by Marshall to the refusal of Chief Justices to assign him more important tasks in constitutional law. A few years after the liberal Marshall joined the Court, it is noted, the moderately conservative Warren Burger was appointed Chief Justice. Moreover, the even more conservative William Rhenquist succeeded Burger. In other words, it is asserted, Justice Marshall was forced to write on federal income tax because he was given nothing better to do.

I am not sure how the claim is relevant to an evaluation of Marshall's work. The quality of his opinions surely is independent of whether Marshall welcomed the chance to write opinions on federal taxation or was unenthusiastic. In fact, if Marshall was drafted into writing tax opinions, the high quality of his work—that he allegedly did not seek or want—might seem all the more impressive.

Another reaction that I have encountered is that Marshall himself did not write the opinions in the tax area but relied on his clerks. I find this second point even more puzzling than the first. Given the Court's workload, nearly every Justice for the past two or three decades has relied on clerks for a great deal of research and writing. Why is one Justice, Thurgood Marshall, in one area, federal taxation, singled out as having depended on his clerks? Marshall served for four years on the court of appeals and more than two decades on the Supreme Court. Surely, the consistent quality of his opinions in federal taxation over this long a period suggests that he himself must have played a significant role in the preparation and writing of his opinions.

A third reaction has been that Marshall must have been biased since in

almost all income tax cases he sided with the IRS and against taxpayers.¹⁴² However, due to its limited litigation resources, the IRS generally seeks Supreme Court review in only the most egregious abuse cases. As a result, Marshall's record of deciding most cases for the IRS is hardly unique. Supreme Court decisions in federal income tax go against taxpayers most of the time, whoever writes the opinion.¹⁴³

In fact, Marshall's writing on federal taxation reflects principled decision-making, rather than systematic pro-IRS and antitaxpayer bias. In two of his six opinions discussed in this essay, Marshall decided for taxpayers even though they engaged in improper conduct. In *Nassau Lens*, the taxpayer manipulated the mismatching of interest expense and interest income in order to defer the taxation of business income for up to a decade. In *Cottage Savings*, the taxpayer, albeit with a federal agency's encouragement, grievously abused accounting principles to avoid disclosing realized losses. Given the taxpayers' unsavory behavior, Marshall could easily have decided against either or both. Instead, he rejected unprincipled arguments made by the IRS in each case and found for the taxpayer.

The Supreme Court is often criticized for its failings in tax cases.¹⁴⁴ Marshall demonstrated that it is possible for a Supreme Court Justice to write intelligently and perceptively in the specialized and complex subject of federal taxation. His opinions are not only an important element of his record as a Justice, but also one of the best arguments for the Supreme Court's continued involvement in the law of federal income tax.

142. While on the Court, Marshall wrote 14 opinions for the Court on the substantive law of federal income taxation. In 13 out of 14, he decided in favor of the IRS. See *Cottage Savings Ass'n v. Commissioner*, 111 S. Ct. 1503 (1991); *United States v. Goodyear*, 493 U.S. 132 (1989); *Hernandez v. Commissioner*, 490 U.S. 680 (1989); *Arkansas Best Corp. v. Commissioner*, 485 U.S. 212 (1988); *United States v. General Dynamics Corp.*, 481 U.S. 239 (1987); *United States v. American Bar Endowment*, 477 U.S. 105 (1986); *United States v. American College of Physicians*, 475 U.S. 834 (1986); *United States v. Mississippi Chem. Corp.*, 405 U.S. 298 (1972); *United States v. Hilton*, 397 U.S. 580 (1970); *Woodward v. Commissioner*, 397 U.S. 572 (1970); *United States v. Davis*, 397 U.S. 301 (1970); *United States v. Donruss*, 393 U.S. 297 (1969); *United States v. Skelly Oil Co.*, 394 U.S. 678 (1969).

143. *Dissent Without Opinion: The Behavior of Justice William O. Douglas in Federal Tax Cases* contains the most comprehensive statistics on Supreme Court decisions on federal taxation: the Court decided for the IRS over 75% of the time between 1939 and 1973. BERNARD WOLFMAN ET AL., *DISSENT WITHOUT OPINION: THE BEHAVIOR OF JUSTICE WILLIAM O. DOUGLAS IN FEDERAL TAX CASES* 141-43 (1973).

144. See, e.g., Bernard Wolfman, *The Supreme Court in the Lyon's Den: A Failure of Judicial Process*, 66 CORNELL L. REV. 1075, 1099-1100 (1981) ("A Supreme Court opinion ought not to become the basis for tax lawyers to make a laughingstock of the Court as they now do It is too much, if not wrong, to expect the Court to develop an enduring and sophisticated tax jurisprudence.").