

Learned Hand's Contribution to the Law of Tax Avoidance

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The extent to which taxpayers are free to minimize their tax obligations by choosing one legal form rather than another as the vehicle for a transaction or relationship has preoccupied lawyers and administrators since the inception of the federal income tax. There is a common awareness among practitioners that different legal procedures will often lead to different tax consequences, although in economic terms the end results are essentially the same. In selecting the form in which a proposed business transaction shall be cast, therefore, it is said to be vital for the tax planner to consider and evaluate "all of the possible routes to his client's destination,"¹ and the ability to generate a multiplicity of formal alternatives, however sterile the exercise in any other context, is usually thought to be the true mark of a creative tax adviser.² But one hastens to add that the planning job does not end there. The Internal Revenue Service does not regard itself in every case as bound by the taxpayer's choice of form, so that a plan which is "jigsaw cut" to the letter of the law may nevertheless be challenged by the government for one reason or another.³ Hence the ability to perceive alternatives in great number can sometimes be a dangerous intelligence unless it is combined with a power to forecast the likely reaction of the Service and the courts to each of the alternatives in view.

The courts themselves follow no single and consistent set of rules in deciding when to accept and when to disregard the taxpayer's choice of form, although there is a conclusory commonplace for either type of determination. Thus when declining to accept the taxpayer's choice of form the courts commonly assert as a matter of principle that the incidence of taxation depends upon the substance of a transaction and that mere form is not controlling.⁴ When, on the other hand, the choice of

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1. B. BITTKER, *PROFESSIONAL RESPONSIBILITY AND FEDERAL TAX PRACTICE* 55 (1965).

2. "When one sees that a given business purpose might be achieved in a particular way, how does one find out whether there are other, possibly better, ways of accomplishing the same purpose? If you have found three possibilities, how can you be sure there is not a fourth? The answer, of course, is that the practitioner must rely on his own experience and training. . . ." *Id.*

3. Darrell, *Some Responsibilities of the Tax Advisor in Regard to Tax Minimization Devices*, N.Y.U. 8TH INST. ON FED. TAX. 983, 988-89 (1950).

4. *E.g.*, *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945).

form is accepted, the appropriate maxim is that “there is nothing sinister in so arranging one’s affairs as to keep taxes as low as possible.”⁵ In practice the first principle means simply that the range of effective choice is limited in the situation under review, or indeed that the only route to the taxpayer’s destination is the one that bears the highest tax. By contrast the second principle, when applicable, confirms that the availability of alternative legal procedures also gives the taxpayer a right of election with respect to the tax consequences. In a considerable measure, the daily work of business and tax planning, and likewise the administrative and judicial work of the Service and the courts in this field, involves the quest for an understanding of and a suitable accommodation between these conflicting postulates.

More perhaps than any other single judge or commentator, Learned Hand was instrumental in the development of the interpretative principles just mentioned. Beginning with an opinion involving the Corporate Excise Tax Act of 1909,⁶ and ending almost forty years later with an obscure and troublesome dissent in the much debated *Gilbert*⁷ case, the relationship between form and substance in tax law engaged Hand’s attention at fairly regular intervals during the entire span of his judicial career. His effort throughout, reflecting that of the tax bar itself, was to draw the line between permissible and impermissible tax avoidance by determining when the taxpayer’s choice of form was to be respected—when a literal construction of the statute was appropriate—and when not.

Hand’s decisions on the subject of tax avoidance were more often criticized than praised by the tax bar; yet it was apparent at an early date that those decisions were likely to prove highly influential in the development of the law. His opinion in *Helvering v. Gregory*,⁸ which established his preeminence as a tax judge, was a major event in the history of tax administration in this country and is still among the most significant and best remembered judicial statements on the subject. The same can be said of his recapitulation of the corporate entity problem in *National Investors Corp. v. Hoey*.⁹ Most recently the Supreme Court paid Hand

5. *Commissioner v. Newman*, 159 F.2d 848, 850-51 (2d Cir. 1947) (dissenting opinion of Hand, J.). The proposition may have been given its ultimate expression by Justice Harlan, concurring in *Commissioner v. Brown*, 380 U.S. 563, 579-80 (1965): “Were it not for the tax laws, the respondent’s transaction . . . would make no sense. . . . However, the tax laws exist as an economic reality in the businessman’s world, much like the existence of a competitor. Businessmen plan their affairs around both, and a tax dollar is just as real as one derived from any other source.”

6. *United States v. Oregon-Washington R.R. & Nav. Co.*, 251 F. 211 (2d Cir. 1918).

7. *Gilbert v. Commissioner*, 248 F.2d 399 (2d Cir. 1957).

8. 69 F.2d 809 (2d Cir. 1934), *aff’d*, 293 U.S. 465 (1935).

9. 144 F.2d 466 (2d Cir. 1944).

the compliment of adopting his *Gilbert*¹⁰ formulation as its own, just as it had done with his opinion in *Gregory*¹¹ twenty-five years before. And in all the writing that has appeared over the years on the function and responsibility of the tax adviser, there is hardly an essay that fails to include some reference to or quotation from Hand's decisions, with the famous lines in *Commissioner v. Newman*¹² being perhaps the most frequently cited and savored.

His influence having been as considerable as it was, there may now be some value in attempting a synthesis and appraisal of Hand's thought on the pervasive question of form and substance in the tax law.

I. Business Purpose and Corporate Entity

Hand's opinions in the *Gregory* and *Chisholm*¹³ cases, together with the extended series of decisions on recognition of the corporate entity which culminated in the *National Carbide*¹⁴ opinion, all in a sense belong to a "period" in the development of his approach to form and substance. That period, generally described, was one in which Hand was preoccupied not only with the issue of liberal as opposed to literal interpretation of the taxing statute as a means of dealing with tax avoidance, but with what perhaps was the more difficult problem of setting appropriate limits once the decision had been made to pursue a liberal course. If his *Gregory* opinion represented the rejection of literalism as a standard of statutory interpretation, the corporate entity decisions just as clearly represented an effort, in a closely related context, to prevent liberalism from exceeding proper bounds.

As a lower court judge Hand's obligation to assimilate and give effect to the views of the Supreme Court on the question of corporate entity—particularly those expressed in *Higgins v. Smith*¹⁵—necessarily complicated that effort. The Court had begun its consideration of the corporate entity under the modern income tax by suggesting, though with ample reservation, that a distinction might be drawn between closely-held corporations, including wholly-owned subsidiaries, and public issue corporations, with the former being treated for certain tax purposes as in-

10. *Knetsch v. United States*, 364 U.S. 361, 366 (1960).

11. "The reasoning of the court below . . . leaves little to be said." *Gregory v. Helvering*, 293 U.S. 465, 469 (1935).

12. 159 F.2d 848 (2d Cir. 1947), p. 441 & note 5 *supra*.

13. *Chisholm v. Commissioner*, 79 F.2d 14 (2d Cir. 1935), *cert. denied*, 296 U.S. 641 (1936).

14. *Commissioner v. National Carbide Corp.*, 167 F.2d 304 (2d Cir. 1948), *aff'd*, 336 U.S. 422 (1949).

15. 308 U.S. 473 (1940).

separable from their shareholders. In *Southern Pacific v. Lowe*¹⁶ the Court held, at the taxpayer's urging, that income accrued to a parent corporation at the same time that it accrued to its wholly-owned subsidiary, even though a dividend was not in fact declared until a subsequent year. The two corporations were found to be in substance identical owing to "the complete ownership and control which the [parent] possessed over the [subsidiary] as stockholder and in other capacities,"¹⁷ so that in effect the subsidiary's income was deemed to have accrued directly to the parent. The Court warned, nevertheless, that its decision should be regarded as turning upon "very special facts," and it presently became clear that no rule of general application to closely-held corporations had been intended. Thus, in *Burnet v. Commonwealth Improvement Co.*¹⁸ the Court held taxable a gain realized by a corporation on a sale of appreciated securities to its sole shareholder. Declining to consider the corporation and shareholder as anything but separate taxable entities, the Court in a brief opinion appeared to devitalize the *Southern Pacific* decision by stating that the latter "cannot be regarded as laying down any general rule authorizing disregard of corporate entity in respect of taxation."¹⁹ And in subsequent decisions, at least prior to *Higgins v. Smith*, the Court either took pains to confirm the separate identity of corporation and shareholder or else reached results which can readily be explained without reference to the factor of shareholder ownership and control.²⁰

During the period preceding the *Smith* decision, Hand wrote opinions in nearly a dozen disregard-of-entity cases and participated without separate opinion in several more, including the Second Circuit's consideration of *Smith*²¹ itself. His own views on the status of the corporate entity for tax purposes were somewhat more constant than the Supreme Court's, as it seems, and although he conceded that the question was a troublesome one, in general he held quite firmly to the position that the statute, having been drafted upon a concept of corporate personality, had to be interpreted to require recognition of the entity in virtually every instance.²² For example, in *United States v. Oregon-Washington*

16. 247 U.S. 330 (1918).

17. *Id.* at 337.

18. 287 U.S. 415 (1932).

19. *Id.* at 420.

20. See Cleary, *The Corporate Entity in Tax Cases*, 1 TAX L. REV. 3, 6-7 (1945).

21. *Smith v. Higgins*, 102 F.2d 456 (2d Cir. 1939), *rev'd*, 308 U.S. 473 (1940).

22. ". . . [W]hen a statute is drafted upon a concept like that of the reality of corporate personality, I do not see how that concept can fail to be determinative." *Sage v. Commissioner*, 83 F.2d 221, 225 (2d Cir. 1936).

R.R. & Nav.,²³ which was decided two months before *Southern Pacific*, the government sought to tax a subsidiary corporation whose indebtedness to its parent had been cancelled by the latter. The taxpayer argued that the transaction should be ignored or treated as mere bookkeeping because of the substantial identity of interest between the two corporations. Rejecting this approach, Hand found that the parent and subsidiary were entirely separate for tax purposes and that the debt cancellation resulted in an addition to the subsidiary's net assets, though he also concluded that the subsidiary's gain was not in the nature of taxable income. Similarly, in *Nixon v. Lucas*,²⁴ decided 12 years later, a partnership owned all of the stock of a corporation which had admittedly been organized "for convenience" and to hold title to certain timber properties. The partnership periodically advanced funds to the corporation to cover its annual deficits, and the partners, contending that the corporation lacked independent substance, sought to treat the advances not as loans but as "contributions by the firm business as a whole to . . . a losing branch."²⁵ Stating that if "a legal transaction arises between a company and those who control it, the relations ensuing are the same as between any other persons,"²⁶ Hand held that the individual taxpayers were bound by their own choice of the corporate form and upheld the disallowance of the deductions. His position on recognition of the corporate entity in these and other early decisions thus seems to have been fully responsive to the obvious point that a statute which taxes corporations under an independent schedule of rates, which contains a variety of rules applicable in particular to corporations and shareholders, and which makes no general distinction between closely-held and publicly-held corporations, simply cannot be interpreted to admit a sweeping principle of corporate disregard based on the factor of shareholder ownership and control.

But as straightforward and well-founded as it appeared to be, this literal approach to the meaning of the word "corporation" proved inadequate to deal with the kind of question presented in *Helvering v. Gregory*²⁷ and in subsequent cases involving overtly conceived tax-minimization schemes. In the *Gregory* case the taxpayer caused her wholly-owned corporation to transfer certain property to a newly-formed corporation whose shares the taxpayer also owned, and then within a few days

23. 251 F. 211 (2d Cir. 1918).

24. 42 F.2d 833 (2d Cir. 1930).

25. *Id.* at 834.

26. *Id.*

27. 69 F.2d 809 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935).

liquidated the new corporation and received the property previously transferred to it. These steps were concededly taken to avoid dividend treatment by complying literally with the tax-free reorganization provisions of the Revenue Act of 1928. The issue for the court was whether, despite such literal compliance, the taxpayer's motive to avoid taxation, or any other factor present in the circumstances, might justify a disregard of the reorganization form.

The Board of Tax Appeals held for the taxpayer:

As long as corporations are recognized before the law as if they were creatures of substance, there is nothing to distinguish [the newly-formed corporation] from innumerable others, whether they be devised to achieve a temporary tax reduction or some other legitimate end. Congress has not left it to the Commissioner to say . . . that the corporate form may be ignored in some cases and recognized in others.

. . . .

A statute so meticulously drafted must be interpreted as a literal expression of the taxing policy, and leaves only the small interstices for judicial consideration.²⁸

Reversing the Board, Hand first confirmed there was nothing reprehensible about minimizing taxes, and then, in a famous simile, dealt with the general issue of statutory interpretation:

We agree with the Board and the taxpayer that a transaction, otherwise within an exception of the tax law, does not lose its immunity, because it is actuated by a desire to avoid, or, if one choose, to evade, taxation. Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes. . . . Nevertheless, it does not follow that Congress meant to cover such a transaction, not even though the facts answer the dictionary definitions of each term used in the statutory definition. It is quite true, as the Board has very well said, that as the articulation of a statute increases, the room for interpretation must contract; but the meaning of a sentence may be more than that of the separate words, as a melody is more than the notes, and no degree of particularity can ever obviate recourse to the setting in which all appear, and which all collectively create.²⁹

But this willingness to abandon literalism in an appropriate case and to rely on liberal interpretation as a means of associating the statutory language with apparent legislative intent was plainly intended by Hand

28. 27 B.T.A. 223, 225 (1932).

29. 69 F.2d at 810-11.

to be a grant of limited authority. Thus while upholding the Commissioner in finding a dividend, Hand also took the trouble to reject the theory on which the Commissioner had specifically relied: namely, that the organization of the new corporation and the transfer of the property to it by the old, being intended solely to avoid taxes, should be viewed as nullities; and, accordingly, that the taxpayer should be regarded as having received the property directly from the old corporation as a taxable dividend. Hand declined to adopt this analysis. Treating the steps taken by the corporations as "real" even though motivated only by a desire to avoid taxes, he found, nevertheless, that "these steps . . . were not what the statute means by 'reorganization,' because the transactions were no part of the conduct of the business of either or both companies . . ." ³⁰ The statute, as he later observed in a paraphrase of the *Gregory* opinion, must be read to mean that "a corporation [created] only to serve as a means of transfer . . . [W]as not a 'corporation' within the meaning of that term as Congress must be understood to have used it. . . . Such a corporation might be in some contexts a 'corporation'; but . . . in a tax statute 'corporation' could not have been so intended."³¹ Since the reorganization for this reason failed, the taxable event was the taxpayer's receipt of the shares of the new corporation, such shares, of course, having a value equal to that of the property transferred by the old.

Hand's approach, which the Supreme Court adopted in affirming his decision,³² was thus merely to interpret the language of the statute; that is, to construe a set of Code provisions embodying the definition of a "reorganization" whose meaning had theretofore been obscure.³³ In so doing, as Randolph Paul observed, he "imparted into the statutory provision, a meaning which made relevant the motive of the taxpayer in taking steps literally within the scope of the . . . reorganization provision."³⁴ The holding that the transaction was a device with no business purpose thus led to the conclusion that the transaction in that respect fell short of the definitional requirements of the statute.

The decision in *Chisholm v. Commissioner*,³⁵ which followed shortly after the *Gregory* case, also shows that Hand saw *Gregory* as having a limited function. In *Chisholm* the taxpayer, with his brother, granted a broker a 30-day option to purchase certain appreciated securities. On

30. *Id.* at 811.

31. *Commissioner v. National Carbide Corp.*, 167 F.2d 304, 306 (2d Cir. 1948), *aff'd*, 336 U.S. 422 (1949).

32. *See* note 11 *supra*.

33. *See* R. PAUL, *STUDIES IN FEDERAL TAXATION* 130 (1937).

34. *Id.* at 152.

35. 79 F.2d 14 (2d Cir. 1935), *cert. denied*, 296 U.S. 641 (1936).

being notified by the broker that the option would be exercised, the brothers formed a partnership to which they transferred the securities subject to option, and on exercise the partnership received the purchase price. Under the rule then prevailing “that when partners transfer property to the firm which in turn sells it, the taxation of any appreciation in its value before the transfer must await dissolution [of the firm],”³⁶ the taxpayer reported no gain at the time of contribution. The Board of Tax Appeals, finding that the transfer represented “an abrupt departure from normal procedure, devised and adopted . . . solely for the purpose of avoiding liability,”³⁷ held that the partners rather than the partnership should be treated as having sold the securities.

The Second Circuit reversed. Emphasizing that the Supreme Court in *Gregory* had been “solicitous to reaffirm the doctrine that a man’s motive to avoid taxation will not establish his liability if the transaction does not do so without it,”³⁸ Hand determined that the partnership entity was fully entitled to recognition. The aspect of “transitoriness” that had been flagrantly present in *Gregory* was, he thought, lacking here since the taxpayer’s purpose was to create an “enduring firm” and since the partnership did in fact continue to hold and manage the capital jointly invested by the brothers. The entity thus served not merely “as a means of transfer,”³⁹ but possessed a further economic function; and that, he thought, sufficed to put the case beyond the reach of *Gregory*. The business purpose requirement was deemed relevant to the status of the partnership as an entity, but once that status had been assured the same requirement evidently had no further bearing upon the characterization of transactions taking place between the entity and its beneficial owners.

Against this background, the Supreme Court’s decision in *Higgins v. Smith*⁴⁰ undoubtedly surprised Hand—as it did others—because it appeared to go well beyond the *Gregory* decision, which it nevertheless cited as authority for its position. In *Smith* the Commissioner disallowed a loss claimed by an individual taxpayer on the sale of certain securities to his wholly-owned corporation. The corporation had been in existence for a number of years prior to the questioned transaction and while it apparently served primarily as a trading partner for its share-

36. *Id.* at 15; see *Helvering v. Walbridge*, 70 F.2d 683 (2d Cir. 1934), *cert. denied*, 293 U.S. 594 (1935).

37. *Chisholm v. Commissioner*, 29 B.T.A. 1334, 1345 (1934).

38. 79 F.2d at 15.

39. *Cf. Electrical Sec. Corp. v. Commissioner*, 92 F.2d 593 (2d Cir. 1937), *discussed in* 3 J. MERTENS, *THE LAW OF FEDERAL INCOME TAXATION* §§ 20.46, 20.56 (1965).

40. 308 U.S. 473 (1940). The case arose prior to the predecessor of present Section 267.

holder, the Commissioner did not suggest either that there had been a failure to transfer actual ownership in the securities to it or that the sale price was below fair market value. Instead his contention was that the loss had not been "sustained" within the meaning of the predecessor of Code Section 165(a).

The case was tried to a jury in the district court, which was instructed to find whether the transaction was a transfer of property by Mr. Smith "into something that existed separate and apart from him" or was merely "a transfer by Mr. Smith's left hand, being his individual hand, into his right hand, being his corporate hand, so that in truth and in fact there was no transfer at all." The jury found that the latter was the situation. The Second Circuit, in a decision in which Hand joined, reversed on the ground that the separate status of corporation and shareholder could not thus be disregarded,⁴¹ but the Supreme Court, through Justice Reed, reinstated the verdict with the observation that the taxpayer's continued domination and control of the property transferred was "so obvious in a wholly-owned corporation as to require a peremptory instruction that no loss in the statutory sense could occur upon a sale by a taxpayer to such an entity."⁴² The Court did not deny that an actual corporation existed or that a transfer of title had taken place, but held that neither was sufficient to justify recognition of the loss. Citing *Gregory* as "precedent for the disregard of a transfer of assets without a business purpose," the Court reached "the natural conclusion that transactions, which do not vary control or change the flow of economic benefits, are to be dismissed from consideration."⁴³

Confronted with its decision in the *Commonwealth Improvement* case, in which gain was recognized on a sale of property by a corporation to its sole shareholder, the Court asserted that the right to disregard transactions between a shareholder and his wholly-owned corporation belongs to the Commissioner alone and is a weapon against tax avoidance rather than a rule of law applicable to all corporate-shareholder dealings. Thus a taxpayer who elects to do business in corporate form is bound to accept the tax disadvantages—such as liability to the corporate income tax—of his election. The Commissioner is not similarly bound, however, and need not acquiesce "in the taxpayer's election of that form . . . which is most advantageous" to himself. At least this is true where, as here, the transaction was "unreal or a sham." In the latter event the

41. *Smith v. Commissioner*, 102 F.2d 456 (2d Cir. 1939).

42. 308 U.S. at 476.

43. *Id.*

Commissioner “may sustain or disregard the effect of the fiction as best serves the purpose of the tax statute.”⁴⁴

Although nominally engaged in interpreting the words “loss sustained,” the Court appeared to think that something more was needed to counter the taxpayer’s ingenuity than could be found in an examination of the legislative history and intent of specific statutory terms or provisions. The emphasis on shareholder control and on “sham” suggests that Justice Reed was bent on arming the Commissioner with a broad form-piercing doctrine which could be employed in defense of the revenues even where the taxpayer had actually succeeded in meeting the requirements of the statute. But while the Court apparently assumed that this doctrine would produce results similar or analogous to those that occurred in *Gregory*, the opinion failed to specify the conditions which would render the doctrine operative and did not make clear what the Commissioner would be authorized to do once those conditions were present.

Subsequently, in *Moline Properties, Inc. v. Commissioner*,⁴⁵ the Court appeared to retreat somewhat from the forward position that it had taken in *Smith*. In *Moline Properties* the taxpayer-corporation contended that gains realized on a sale of real estate held in corporate name should be taxed to its sole shareholder rather than the corporation. The taxpayer had been formed as a security device at the demand of a mortgagee, but also engaged in certain litigation in respect to the real estate, refinanced the property at one point, and for a brief period leased a portion of the property and received and reported the rents. The Court found that these activities were sufficient to compel recognition of the corporate entity for tax purposes and held the gains taxable to the corporation. Apparently intending its remarks to apply not only to a taxpayer seeking disregard of the corporate entity but to the Commissioner as well, the Court stated that “whether the purpose [of incorporating] be to gain an advantage under the law of the state of incorporation or to avoid or to comply with the demand of creditors or to serve the creator’s personal or undisclosed convenience, so long as that purpose is the equivalent of a business activity or is followed by the carrying on of a business by the corporation, the corporation remains a separate taxable entity.”⁴⁶ The Court distinguished *Higgins v. Smith*, as well as *Gregory*, by stating that those decisions authorized disregard of the corporate

44. *Id.* at 477-78.

45. 319 U.S. 436 (1943).

46. *Id.* at 438-39.

form (now, however, apparently at the Commissioner's insistence alone) only where the corporation was "a sham or unreal . . . a bold and mischievous fiction"; and while it essayed no definition of "sham," it is clear from the way in which the *Moline Properties* opinion is structured that the Court now viewed the *Smith* decision as but a limited exception to the customary and much more general rule of corporate recognition.

While the *Smith* decision was commended by some for its simple realism in dealing with an obvious effort at tax-avoidance,⁴⁷ even those who praised it conceded that its rationale was—especially in view of *Moline Properties*—difficult to isolate. Hand, it appears, found the decision extremely puzzling. His own construction of *Gregory*, as revealed in *Chisholm*, emphasized a requirement of economic function in respect to the entity or other status for which the taxpayer claimed some consequence, and it was obviously a construction much more limited than the broad form-piercing doctrine that the Court seemed to support. Nevertheless, and while making no secret of his difficulty with it, Hand set about to apply the *Smith* decision in subsequent cases, stressing first one and then another of the several aspects of Justice Reed's loosely written opinion in an effort finally to comprehend its effect.

Hand at first regarded *Moline Properties* as having confirmed his own approach to the tax status of the corporate entity and the proper construction of the *Gregory* case prior to the uncertainty introduced by *Smith*. He summed up the effect of the *Moline Properties* decision as follows:

The gloss then put upon *Higgins v. Smith* . . . was deliberate and is authoritative; it was that, whatever the purpose of organizing the corporation, "so long as the purpose is the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a taxable entity." That, as we understand it, is the same interpretation which was placed upon corporate reorganization in *Gregory v. Helvering* . . . and which has sometimes been understood to contradict the doctrine that motive to avoid taxation is never, as such, relevant. In fact it does not trench upon that doctrine; it merely declares that to be a separate jural person for purposes of taxation, a corporation must engage in some industrial, commercial, or other activity besides avoiding taxation: in other words, that the term "corporation" will be interpreted to mean a corporation which does some "business" in the ordinary meaning.⁴⁸

47. Surrey, *The Supreme Court and the Federal Income Tax: Some Implications of the Recent Decisions*, 35 ILL. L. REV. 779, 795 (1941); cf. Rudick, *The Problem of Personal Income Tax Avoidance*, 7 LAW & CONTEMP. PROB. 243, 258 (1940).

48. *National Investors Corp. v. Hoey*, 144 F.2d 466, 467-68 (2d Cir. 1944) (italics added).

Curiously, however, this expression of settled conviction about the relatively narrow importance of *Higgins v. Smith*—a conviction that the *Smith* decision was essentially of a piece with his own interpretation of *Gregory*—seemed to give way slightly in the *National Carbide*⁴⁹ case, the last of his opinions dealing strictly with the status of the corporate entity. The question in *National Carbide* was whether income received by three operating subsidiaries was, as the taxpayer argued, taxable to the parent corporation rather than the subsidiaries, the former having furnished all of the subsidiaries' assets and having managed their entire operations. Finding that the subsidiaries could not be ignored for tax purposes once the parent had chosen to use them "as a convenient method of actually conducting . . . business," Hand nevertheless felt compelled to suggest or concede that the *Smith* decision might really have to be taken as having added something to *Gregory* or, perhaps, as having expressed a broader view of the *Gregory* decision than he himself had intended:

It is true that Reed, J., also cited *Higgins v. Smith* as an authority in *Moline Properties, Inc. v. Commissioner* . . . , and it does not appear from the opinion in that case that the court thought that [Smith] had organized the Innisfall Corporation only to escape taxation, or for any other purpose which put it outside the fair intendment of the word. Certainly, we had not thought so, when the case was before us. The decision may therefore make it possible for the Treasury at times to disregard transactions between its shareholders and [their] corporation even though it be a "corporation" in the sense we mean, although it must be confessed that the differentia is left open. We read that decision more broadly in *United States v. Morris & Essex R. Co.*, but it does not follow that we should not be equally wrong to circumscribe it.⁵⁰

The paragraph last quoted shows that *Hand* now saw the *Smith* decision as authorizing disregard "at times" of particular dealings between a shareholder and his corporation; and in that respect, at least, the decision appeared to add range to the *Gregory* principle. He also seemed fairly certain in the *National Carbide* opinion that the Supreme Court had in *Smith* intended business purpose to be a doctrine running solely in the Commissioner's favor and not a rule of law. But even then it remained unclear why a legal transaction with a valid entity involving no distortion of property values should have been considered "a bold

49. *Commissioner v. National Carbide Corp.*, 167 F.2d 304 (2d Cir. 1948), *aff'd*, 336 U.S. 422 (1949).

50. *Id.* at 307 (footnotes omitted) (italics added).

and mischievous fiction." This, in turn, raised doubts concerning the specific content of the business purpose requirement—"the differentia," as Hand put it.

In summary, the cases discussed above show that Hand's characteristic interpretation of the *Gregory* doctrine was one which emphasized its limitations rather than its scope or breadth. This, perhaps, reflects the fact that in *Gregory* itself, as in the other decisions that have been mentioned, the problem of permissible tax avoidance was presented to him, at least in part, as if it involved the question of regard or disregard of the corporate entity. As a consequence, the business purpose requirement was apparently intended to do no more than establish a modest threshold of legitimacy, one which would exclude transitory legal arrangements in some instances and little else. In Hand's conception of it, the business purpose doctrine was thus in a sense an affirmation that form controls substance, but with the qualification that the form adopted must be functional in some respect.

II. Application of the *Gregory* Decision

As noted, Hand warned in the *National Carbide* opinion against too narrow a reading of *Smith*, and it is conceivable that in his struggle to domesticate the latter some reshaping of his own attitudes occurred. In any event, in what may be somewhat artificially regarded as a subsequent phase in the development of his treatment of tax avoidance problems, Hand apparently attempted to extend the technique of statutory interpretation adopted in *Gregory* to dealings between shareholders and corporations whose status as independent entities was otherwise unquestioned. These later decisions—notably *Fairfield Steamship Corp. v. Commissioner*⁵¹ and *Commissioner v. Transport Trading & Terminal Corp.*⁵² struck the tax bar as quite radical in their application of the *Gregory* approach, and they were generally criticized for having placed unwarranted restrictions on a taxpayer's previously acknowledged freedom to make an advantageous choice of form.⁵³

Both *Fairfield Steamship* and *Transport Trading* involved the distribution of an appreciated asset by a subsidiary corporation to its parent in advance of, but also in contemplation of, a sale of the asset to a

51. 157 F.2d 321 (2d Cir. 1946), *cert. denied*, 329 U.S. 774 (1947).

52. 176 F.2d 570 (2d Cir. 1949), *cert. denied*, 339 U.S. 916 (1950).

53. See Bierman, *Corporate Distributions of Appreciated and Depreciated Property: Gain or Loss to the Distributor*, N.Y.U. 8TH INST. ON FED. TAX, 792 (1950); Sutherland, *Taxpayers' Motive as a Basis for Taxability*, N.Y.U. 8TH INST. ON FED. TAX, 990, 1001 (1950).

third party. In *Fairfield Steamship* the individual shareholders of the parent had determined upon a liquidation of both the parent and the subsidiary and had employed a broker to arrange the sale of the subsidiary's principal asset, a ship. Since the parent had losses which it could offset against gain to be realized on the sale, the subsidiary was liquidated and its assets transferred to the parent as soon as a satisfactory offer for the ship had been received, and the parent then entered into a formal contract of sale with the buyer. The Commissioner sought to tax the gain to the subsidiary, which had no offsetting losses, and was sustained by a majority of the Tax Court on the ground that the situation was controlled by the Supreme Court's decision in *Commissioner v. Court Holding Co.*⁵⁴

Affirming, Hand nevertheless agreed with the dissenters below that the negotiations in the present case had been carried on by the parent corporation and not by the subsidiary, and he therefore expressly declined to rely on the *Court Holding Co.* decision. Instead he held that the transfer of the ship from subsidiary to parent pursuant to a decision to terminate the venture was not a "distribution" in liquidation within the meaning of Section 112(b)(6) of the 1939 Code, which, like present Section 332, provided that a parent corporation shall recognize no gain or loss on the liquidation of a controlled subsidiary. That section, in his view, presupposed a "union in one corporate form" of a continuing enterprise and not a winding up of the corporate business by both parent and subsidiary. Accordingly, he found "the situation . . . to be like that in *Gregory v. Helvering* . . . where although the taxpayer followed step by step the provisions of the statute, and was therefore literally entitled to escape, the Supreme Court held that the section must be interpreted in the light of its purpose, and not merely as a verbal mosaic."⁵⁵

Despite the inapplicability of Section 112(b)(6), however, Hand's reason for taxing the subsidiary was by no means satisfactory or even clear. If, as he said, the liquidation was not within the Section, the only apparent consequence was that the liquidating distribution should have been treated as a taxable event to the parent, with the parent recognizing gain (or loss) measured by the difference between

54. 324 U.S. 331 (1945). In *Court Holding Co.*, the taxpayer-corporation had completed negotiations for the sale of an appreciated apartment building but abruptly called off the negotiations and distributed the building to its shareholders in liquidation. The shareholders then sold the building. The Supreme Court held that the corporation was taxable on the gain from the sale of the property on the ground that "the executed sale was in substance the sale of the corporation." *Id.* at 334.

55. 157 F.2d at 323.

the value of the assets received in liquidation and its basis for the stock of the subsidiary. By itself, therefore, the inapplicability of Section 112(b)(6) did not justify a tax on the subsidiary; and once the *Court Holding Co.* decision had been found not controlling on the facts, the only issue left, as it seemed, was whether the subsidiary's act in distributing the appreciated asset by itself constituted a taxable "disposition" of the property. The latter question, however, had previously been considered by the Supreme Court in the *General Utilities*⁵⁶ case and had been decided in a manner favorable to the taxpayer. Hence the *Fairfield Steamship* opinion seemed to resolve itself into nothing more than a substantial gaffe; and the commentators, disliking the result, were not slow to point that out.⁵⁷

Curiously, in view of this, Hand employed very much the same sort of analysis in the *Transport Trading* case, where a subsidiary corporation distributed an appreciated asset to its parent as a dividend in kind. The parent promptly sold the asset to a purchaser whom it had previously secured, and having included the dividend in full (subject, however, to the 85 per cent intercorporate dividend credit), the parent claimed a basis for the property equal to its market value and reported no further gain. The Commissioner sought to disregard the dividend in kind and urged that the gain should be taxed to the subsidiary as if the latter and not the parent had sold the property. Hand agreed, reversing the Tax Court which had held for the taxpayer. In an opinion that drew heavily on *Gregory* and *Fairfield Steamship*, he reasoned that the distribution was not of the sort which 1939 Code Section 115(a) had been intended to cover. That section defined a dividend as a "distribution made by a corporation to its stockholder whether made in money or other property," and hence clearly included dividends in kind. This, however, was insufficient in view of the interpretive approach of *Gregory v. Helvering*, which, he said "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 but to escape taxation."⁵⁸ Since the parent corporation had already determined to sell the property at the time it caused the subsidiary to declare the

56. *General Utils. & Operating Co. v. Helvering*, 296 U.S. 200 (1935).

57. See Bierman, *supra* note 53; Kurz, *A Critique of the Fairfield Steamship Case*, 25 TAXES 612 (1947); Note, *Double Taxation Upon Sale of Corporate Assets*, 56 YALE L.J. 379, 382 (1947); *Tax Notes*, 32 A.B.A.J. 516 (1946). For a discussion of the current status of the *Fairfield Steamship* decision, see D. HERWITZ, BUSINESS PLANNING 648-52 (1966).

58. 176 F.2d at 572.

dividend, the dividend "was not a distribution for the purposes of the parent's business, but only in order to escape a tax and such a 'distribution' is not among those contemplated in the Section."⁵⁹

Again, therefore, as in *Fairfield Steamship*, Hand's analysis turned upon the purported intent of a section which was not specifically directed at the tax treatment of the distributing corporation and hence might well be thought to have lacked sufficient relevance to be determinative. And even if the policy of Section 115(a) were conceded to be in some way relevant, his description of that policy seems questionable. Thus a dividend generally requires no justification in terms of its relationship to the shareholder's business activities; certainly that is true of a cash dividend, and if so, why not also of a dividend in kind which is intended shortly to be reduced to cash? Furthermore, in contrast to *Gregory*, neither *Fairfield Steamship* nor *Transport Trading* involved an effort to bail out earnings and profits through interposition of a transitory entity. Rather, both involved a bona fide sale of property to a third party; and it is not at all clear, even now, why normal commercial or industrial practice should be thought to require a sale of the property by the subsidiary followed by a distribution of the proceeds, rather than a distribution of the property followed by a sale by the parent. Hand's observation in *Transport Trading* that "the proceeds of the sale were in any event to reach the same treasury," would seem to leave in perfect equilibrium the question whether the parent or the subsidiary should be treated as the seller, and to provide no more support for one conclusion than the other.⁶⁰

The *Fairfield Steamship* and *Transport Trading* decisions may be compared with the approach taken by the Supreme Court in the *Court Holding Co.*⁶¹ and *Cumberland Public Service*⁶² cases, which also presented the question whether a corporate level tax should be imposed in the distribution-and-sale situation. Taken together the latter cases show that the Court ultimately settled on a factual distinction in this area, albeit one that rapidly reduced itself to mere form: if negotiations for the sale of the property were conducted by the shareholder in his individual capacity, then a distribution in advance of sale would be effective to avoid the corporate tax; if such negotiations were conducted by the shareholder in his capacity as corporate officer, a cor-

59. *Id.*

60. *Id.*

61. Note 54 *supra*.

62. *United States v. Cumberland Pub. Serv. Co.*, 338 U.S. 451 (1950). See Cary, *The Effect of Taxation on Selling Out a Corporate Business for Cash*, 45 ILL. L. REV. 423 (1950).

porate tax would be imposed despite the distribution.⁶³ To be sure, this approach led to absurdities in practice; yet it was difficult to suggest any other principle of an *objective* character that would actually succeed in moving the problem away from dead center.

For this very reason, perhaps, in appraising Hand's opinions in *Fairfield Steamship* and *Transport Trading*—with their confusing or mistaken reliance on the policy of Code provisions apparently directed only or primarily at the distributee—the suspicion arose in some quarters that a motive test might really have been at work in his analysis. Moreover, the key language of the *Transport Trading* decision—“transactions entered upon for no other motive but to escape taxation”—together with the absence from that opinion of the familiar assertion that a purpose to avoid tax must be taken as neutral, seemed to provide some basis for the feeling that he had at last succumbed to the lure of a subjective standard, and that motive had become the touchstone.⁶⁴

But on the other hand this could hardly have been so—or else he wavered badly in his view of the matter—because the *National Carbide* case, which contains a forceful rejection of the notion that a “motive to escape taxation . . . is ever decisive,” was decided two years after the *Fairfield Steamship* case and preceded by only a few months the decision in *Transport Trading*. Indeed within the same three-year period he wrote what is undoubtedly the most eloquent short defense ever to appear of the state of being tax-conscious and, by implication, of the art of tax planning:

Over and over again courts have said that there is nothing sinister in so arranging one's affairs as to keep taxes as low as possible. Everybody does so, rich or poor; and all do right, for nobody owes any public duty to pay more than the law demands: taxes are enforced exactions, not voluntary contributions. To demand more in the name of morals is mere cant.⁶⁵

While there is in this quotation a curious echo of Anatole France's classic irony about the law's impartiality, we have it on good authority that in speaking thus Hand “spoke . . . fervently.”⁶⁶ Certainly it is true that he had a “penchant for logical statement”;⁶⁷ and with his

63. See B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS §91 (1966).

64. See Sutherland, *supra* note 53.

65. Commissioner v. Newman, 159 F.2d 848, 850-51 (2d Cir. 1947) (dissenting opinion).

66. Darrell, *supra* note 3, at 989.

67. Finkelstein, *The Corporate Entity and the Income Tax*, 44 YALE L.J. 436, 449 (1935).

obvious willingness (demonstrated by his struggle with *Higgins v. Smith*) to highlight rather than bypass the difficulties encountered in reasoning consistently about the problem of form and substance, it seems unlikely that he would have permitted himself, under cover of some novel inference about legislative purpose, to indulge an idea for which he usually reserved his best expressions of contempt. Nevertheless, the *Fairfield Steamship* and *Transport Trading* decisions are confusing because they fail to make it clear why "function" was thought to be lacking in the circumstances under consideration. Moreover, although different Code sections were involved, both decisions seem at odds with the reasoning of the *Chisholm* case, in which a transfer of appreciated property in obvious contemplation of sale was approved on the ground that the transferee-entity could not be disregarded. Accordingly, even if a sweeping motive doctrine were excluded, there remained a question whether some version of the form-piercing doctrine apparently adopted by the Supreme Court in *Smith* was really being applied.

The assumption (or faith) that Hand did not intend at any time to abandon his resistance to a motive test receives additional support from his opinion in *Loewi v. Ryan*⁶⁸—a decision, however, which also serves to point up a major question in respect to the logic of his approach to tax avoidance. In *Loewi* the taxpayer had made a sizeable loan to another individual which was repayable on demand. The loan was secured by corporate stock plus a fractional interest in a stock exchange seat. The borrower never repaid any part of the loan, and although the taxpayer admitted that she knew as early as 1937 that collection apart from the security was hopeless, she did not foreclose on the security until 1944 and in that year claimed a bad debt deduction for the unpaid balance of the loan. While the Code expressly allowed a deduction only for debts which were "entirely worthless," the government contended that the taxpayer's delay in liquidating the security was motivated solely by a desire to postpone the deduction, and that the bad debt should have been claimed in 1937 since it was then apparent that the borrower's capacity to repay was limited to the collateral.

The issue was tried to a jury in the district court, which found for the government after being instructed that the postponement of a bad debt deduction could not be permitted solely because of the existence of valuable security unless the creditor's delay in liquidating was

68. *Loewi v. Ryan*, 229 F.2d 627 (2d Cir. 1956).

"shown to have been in good faith and bona fide."⁶⁹ On appeal the Second Circuit reversed, Judge Frank dissenting. Writing for the majority, Hand stated that the privilege of a secured creditor to decide when to sell the property pledged could not be encumbered "with such conditions as 'good faith,' and 'common sense' or 'economic reality,'"⁷⁰ but on the contrary must be accorded "its full measure." A taxpayer, he said, is "privileged to liquidate his security for whatever purposes he thinks most profitable, among them the reduction of his taxes. It is so abundantly settled in decisions of the Supreme Court that a taxpayer's motive is irrelevant in determining his liability that we need not cite the very numerous decisions of the lower courts."⁷¹

The *Loewi* decision is thus convincing evidence that Hand continued to find motive an unacceptable test of the sufficiency of form for tax purposes. Even more important, perhaps, it is also a reminder that Hand could, on occasion, give the statute quite a literal reading, and that he evidently did not consider business purpose to be a universal statutory requirement. Thus the business purpose issue was clearly posed by the trial judge's instruction. In the absence of any reasonable non-tax explanation for a secured creditor's delay in foreclosing his collateral, would it not be appropriate to imply foreclosure within a reasonable time after default and after it had become apparent that the debtor lacked independent means to repay the debt? Such a rule, at least, would place secured and unsecured creditors on an equal footing in respect to the bad debt deduction, while adding little to the burden of administering a provision which in any event requires a nice judgment about the year in which actual worthlessness occurs. It was no answer, as Judge Frank pointed out in his dissent, to assert that considerations of motive are generally irrelevant in tax controversies: rather, the question of importance was whether the bad debt section (like the reorganization provisions) might be said to require a showing of business purpose on the part of a secured creditor seeking to postpone recognition, or whether the creditor is free to preserve the form of outstanding indebtedness even though nothing is achieved through delay apart from taxes. Hand's reaction, however, was quite clear and quite negative. He concluded his opinion by stating simply that "in the case of 'non-business debts' the existence of any security, not merely nominal in value, prevents the debts from being 'entirely worth-

69. *Id.* at 628.

70. *Id.* at 629.

71. *Id.* The decision is criticized in Note, *Secured Bad Debts: Manipulation of Deductions by Postponing Liquidation of Security*, 65 YALE L.J. 1045 (1956).

less,'⁷² and in this way he made it plain enough that formal compliance was all that the bad debt section required.

But this willingness to be literal, at least occasionally, and to exclude considerations of commercial substance in some instances, also raises a central question concerning Hand's technique of statutory interpretation which the *Loewi* opinion does not attempt to answer. Thus why is formal compliance sufficient in some cases and not in others? Why is business purpose a necessary ingredient in reorganizations, liquidations and dividend distributions, but not in respect to the liquidation of his security by a credit or claiming a bad debt deduction? A resort to liberal interpretation in applying some but not all sections of the Internal Revenue Code may well be justified, but if so the justifying elements ought to be expressed. If they are not, then the process of selective application takes on an arbitrary and capricious look. Even this, perhaps, can be rationalized by saying, as it has been said, that the resulting uncertainty is to be valued for its *in terrorem* effect on "would-be tax manipulators." But once again, Hand's tireless rejection of "motive" as an explanation of the *Gregory* decision suggests that deterrence was never *his* objective. If anything is clear from his decisions in this field it is that he considered tax-avoidance to be respectable.

It must be admitted, nevertheless, that the *Fairfield Steamship* and *Transport Trading* decisions do have an *in terrorem* quality. The reason for this is that the procedure employed by Hand and sanctioned by *Gregory*—that of reading unwritten definitional requirements into particular Code provisions—was unsatisfactory and unconvincing in those cases. Moreover, as the *Loewi* decision showed, the important question of when it is appropriate to resort to liberal interpretation in applying the statute remained largely, perhaps wholly, unresolved.

III. The *Gilbert* Synthesis

Hand's dissent in the *Gilbert* case—which marks his last major encounter with the subject of tax avoidance—is especially notable in view of the uncertainties discussed in the preceding sections both because it bears upon the question of statutory interpretation raised by the *Loewi* decision and because it in some measure explains the curious results Hand reached in the *Fairfield Steamship* and *Transport Trading* cases. It also shows that after deciding the latter cases by applying the "living language" technique of *Gregory*, Hand

72. 229 F.2d at 630.

still felt a need to return to and re-examine general principles. His attempt to reformulate the business purpose rule, setting it off between quotation marks⁷³ as if confident of having found a permanent form of expression, was plainly the result of that re-examination. Although brisk and even cryptic at certain points, the *Gilbert* opinion ranks with the most important of his essays on tax avoidance.

In *Gilbert*, the taxpayer and another individual were equal shareholders of a corporation which had engaged with little success in a variety of business ventures. The shareholders, together with the taxpayer's wife, had made periodic advances to the corporation roughly in proportion to their stockholdings, such advances being represented in part by interest-bearing notes. No payments were ever made by the corporation, either of interest or of principal. Having become insolvent the corporation was liquidated and the taxpayer sought to deduct his share of the advances as a bad debt. The Commissioner disallowed the bad debt deduction and was sustained by the Tax Court for the stated reason that "the advances . . . were, in reality, contributions of risk capital and did not give rise to bona fide debts on the part of the corporation."⁷⁴

The Second Circuit, finding that the Tax Court had failed to set forth adequate grounds for its conclusion, remanded the case for further proceedings. But in what might otherwise have been a fairly routine appeal, a panel consisting of Judges Medina, Waterman and Hand produced three separate opinions, of which at least two, Medina's and Hand's, were centrally concerned with the effect of the *Gregory* doctrine upon the taxpayer's status as creditor or shareholder.

Judge Medina, writing for the court, applied the *Gregory* case in a conventional manner. That case, he said, is authority for the proposition that statutory terms are to be interpreted in the light of their context and underlying purpose, and not in a spirit of wooden literalism. An obvious consequence of adopting this canon of interpretation is that simulated transactions—transactions which in effect are negated by "some secret agreement"—will be ignored for tax purposes. A further consequence, and one more serious to the taxpayer in *Gilbert*, is that even where a real transaction has occurred, the Commissioner or

73. I would therefore substitute this which seems to me to . . . state the doctrine adequately:

"When the petitioners decided to make their advances in the form of debts, rather than of capital advances, did they suppose that the difference would appreciably affect their beneficial interests in the venture, other than taxwise?"

The burden will be on them to prove that they did so suppose.

Gilbert v. Commissioner, 248 F.2d 399, 412 (2d Cir. 1957).

74. 15 CCH Tax Ct. Mem. 688, 694 (1956).

a court may disregard it if the reality that has been achieved fails to accord with the meaning that Congress had in mind when it formulated the Code provisions in question. In this context the Commissioner or a court is entitled to inquire whether a purported loan is “indebtedness” as that term is used in the statute, or is simply a contribution to capital. A federal standard governs that determination, and under it the significant question is “whether the funds were advanced with reasonable expectations of repayment regardless of the success of the venture or were placed at the risk of the business. . . .”⁷⁵ Finally, the latter question is to be answered by weighing certain key evidentiary factors, including debt-equity ratio, proportionate stockholding, and the presence or absence of normal creditor safeguards. The Tax Court’s error, apparently, lay in its having collapsed the last step into the one before it; that is, in having concluded in short-hand fashion that the taxpayer’s advances had been placed at the risk of the business without first having made specific findings with respect to the evidentiary factors just mentioned.⁷⁶

Hand’s dissent is also built on the foundation of the *Gregory* case and relies on the familiar proposition that the “literal meaning of the words of a statute is seldom, if ever, the conclusive measure of its scope.” On that base, however, Hand erected a structure quite different from the one created by the majority. His opinion begins with the flat assertion that the Tax Court was wrong in finding that the taxpayer’s advances to the corporation did not create bona fide debts, “if by ‘bona fide debts’ one means debts that are valid as between [the taxpayer] and the corporation.”⁷⁷ The law is clear, he said, that debts to shareholders are, in the event of the corporation’s insolvency, on a parity with debts to outsiders. An enforced subordination of shareholder-owned indebtedness might occur where the shareholder had made unconscionable use of his control position to injure the corporation to his own advantage; but the mere fact that he possessed the opportunity to do so is not of itself sufficient to impose on him a fiduciary relation vis-à-vis other creditors. Finding that the corporation’s debt to Gilbert was in this sense bona fide, Hand evidently also concluded that the term “indebtedness” or “debt” as it is used in the Internal Revenue Code encompassed the notes in question.

75. 248 F.2d at 406.

76. On remand the Tax Court duly elaborated its findings and affirmed its previous conclusion. *Gilbert v. Commissioner*, 17 CCH Tax Ct. Mem. 29 (1958), *aff’d*, 262 F.2d 512 (2d Cir. 1959), *cert. denied*, 359 U.S. 1002 (1959).

77. 248 F.2d at 410.

While the majority in *Gilbert* tested the purported debt by asking whether it possessed "substantial economic reality," Hand's simpler test asked merely whether the obligation actually created would have been treated as debt for nontax purposes. What is important in this, however, is not that Hand was prepared to accept a different test of "indebtedness" than the majority—indeed the two may well subsume many of the same criteria—but that his conclusion on that score did not end the enquiry for him. By contrast, if the majority had been as willing as he to say that since the obligation was debt for nontax purposes it was also debt within the meaning of the tax law, then quite obviously a judgment for the taxpayer would have followed. Hand, however, went on to superimpose a further requirement, relating not to the character of the corporation's obligation but to the legitimacy of the individual taxpayer's investment objectives. The crucial further question, as he saw it, was this: " 'When the petitioners decided to make their advances in the form of debts, rather than capital advances, did they suppose that the differences would appreciably affect their beneficial interests other than tax-wise?' "78 If they did not so suppose and in fact there was no such effect, then presumably the bad debt would be denied. Hand thus appeared to believe, to turn his question into a statement, that in order to overcome the Commissioner's action in disallowing the bad debt deduction, the taxpayer should be obliged to show that some appreciable nontax consequence flowed or was expected to flow from his decision to invest in debt securities rather than additional shares of stock.

In proposing this test, Hand evidently contemplated *both* that the corporate debt would be recognized as such and that the taxpayer might fail in his effort to demonstrate an investor business purpose. In other words the corporation could be treated as having valid debt outstanding, while the taxpayer, for want of a business purpose or an economic effect, might at the same time be denied a bad debt deduction. But since the total effect then appears somewhat anomalous, the question that obviously arises is how the two ideas can exist together, how a court could both respect the debt as such and still deny the deduction when the debt proved worthless.

The answer, perhaps, is that in proposing an investor business purpose test Hand was focusing on the *transaction* between the taxpayer and the corporation, rather than (or after he had finished considering) the character of the security. The point is easier to see in the context of a payment of interest or principal, although it applies as well to a

78. *Id.* at 412.

disposition of the debt through worthlessness. If, for example, a shareholder-creditor receives from his corporation cash purporting to be a payment of debt principal, there is at least a question as to whether the taxpayer's characterization of the transaction is the best or only one available. An alternate and equally plausible characterization is to say that there were two disconnected transactions, a contribution to capital by the shareholder in the form of cancelled debt, and a simultaneous distribution of cash to the shareholder by the corporation. To put it otherwise, it is as consistent with events to say that the individual received the payment as shareholder as it is to say that he received the payment as creditor, and as consistent to say that the debt was cancelled as to say that it was paid. The same sort of observation can be made of an alleged interest payment, which in the alternative can be viewed as a distribution combined with a cancellation of the interest claim. And where, as in *Gilbert*, an insolvent corporation is liquidated and transfers assets worth less than the face amount of its shareholder-owner indebtedness, as an alternative to treating the debt as partly paid and partly worthless the transaction can be described as a voluntary cancellation of the entire debt by the shareholders and a distribution in redemption of the corporation's stock. In each case, as stated, the alternative description—under which the payment and the debt satisfaction are viewed as separate transactions—reflects the bare outline of events no less accurately than the form chosen by the parties, under which payment and debt satisfaction are viewed as an exchange. The question of which description to adopt is thus directly posed.

Since he had already decided that the notes held by the taxpayer were valid debt, the test that Hand proposed in *Gilbert* could only have been directed at this further problem of how to characterize the partial repayment. Were the amounts received by the taxpayer from his corporation received as a creditor and in partial satisfaction of the debt, or were they received by him as a shareholder with the debt being cancelled as a contribution to capital? Rejecting the possibility that form alone might furnish the answer, Hand chose to place upon the taxpayer the burden of resolving the characterization problem by showing that the formal allocation actually *meant* something to him as an investor. The implication, quite obviously, was that in the absence of such a showing the Commissioner would be free to insist upon the characterization most favorable to the revenue. On the other hand, if the taxpayer could demonstrate that the status of corporate creditor had or was expected to have some appreciable economic effect on him which would not have occurred through stock ownership alone, then any

normal transaction which flowed from that status was bound to be recognized, for, as Hand said, "it would be absurd to hold that [the taxpayer] must deny himself an economic advantage unless he pay the tax based upon the facts that have ceased to exist."⁷⁹ In all this Hand raised no question of regard or disregard of the corporate entity, nor was any weight given to the presence of a motive to avoid taxation. Rather, Hand proposed an interpretative rule of general application, authority for which he purported to find in *Gregory* and *Smith*. That rule, briefly stated, was that ambiguous transactions were to be characterized in the Commissioner's favor, unless the taxpayer could dispel the ambiguity by showing that the form which he had chosen carried with it, or was expected to carry with it, some appreciable economic effect beyond tax savings.

But the foregoing, even if an accurate description of Hand's aims in *Gilbert*, still leaves open the question of why he chose to write as a dissenter. Having found as a matter of law that a shareholder-creditor may participate on a parity with other creditors in bankruptcy, why was he nevertheless prepared to affirm the result reached by the Tax Court? The answer may lie, quite simply, in his evaluation of the significance to the taxpayer of non-subordination, remembering that the test he proposed in *Gilbert* was one of "appreciable" effect. Certainly

79. *Id.* at 411. The phrasing of the "appreciable effect" test in *Gilbert* suggests that Hand viewed the question of investor business purpose as arising only at the time the debt securities were issued, that is, at the time "[w]hen the petitioners decided to make their advances . . ." To be sure, the question *would* arise at that time, and it might, for example, be important in determining whether the shareholder had then received taxable "boot" under Section 351 (supposing the debt to be of the short-term variety) and correspondingly whether the corporation's basis for any non-cash assets transferred to it should be increased thereby. See Rev. Rul. 56-303, 1956-2 CUM. BULL. 193. It would not, however, be especially consistent with the approach suggested in the text for the character of subsequent transactions, such as purported payments of interest or principal, to be determined solely on the basis of the taxpayer's investment objectives at the time the debt was issued. Instead the "appreciable effect" test would seem properly to apply to each transaction at the time it occurs. It may be that Hand somewhat hastily assumed that the initial judgment concerning the presence or absence of investor business purpose would continue to hold good as long as the taxpayer's dual status as shareholder and creditor remained unaltered. Quite probably that is so as a practical matter, but it is also true that later events (most notably, a change from pro rata to non-pro rata holding of debt and stock) ought logically to have a bearing on the characterization problem as well.

Of course the same theoretical need for a continuing review may exist even when, in conventional fashion, the classification of an instrument as debt or equity is made on the basis of factors relating to the corporation's capital structure, *e.g.*, whether the ratio of debt to equity is "excessive" by some standard. A corporation whose equity component was found to be too thin to support debt classification in one year would presumably be free to raise the question again in a later year by issuing new debt securities against unrealized property appreciation or accumulated earnings, or, less clearly, by advancing the contention that the original securities which were issued as debt but reclassified as stock should now again be reclassified as debt because the equity proportion has in the meanwhile become greater. In the end the problem of periodic reconsideration could be wholly avoided only by adopting a rule that the form of the instrument at all times controls its classification.

it is not unusual for the courts in tax cases to reject an allegation of business purpose on the ground that the purpose tendered is after the fact or too remote for serious consideration, even though such a rejection necessitates a scrutiny of the taxpayer's motives.⁸⁰ And since in the light of his own standard he should otherwise have voted to reverse, Hand's willingness to affirm the Tax Court suggests that he made just such an appraisal of the non-subordination factor. In effect, although sufficient in Hand's view to distinguish debt from equity, non-subordination was simply not a factor likely to be regarded as important by the owners of a closely-held concern whose only source of unsecured investment capital was its shareholders. He would not, of course, have been alone in making that appraisal; nothing is more common in the literature on thin capitalization than the observation that it is "immaterial to a shareholder-creditor from a nontax standpoint in many situations whether his investment is in debt or equity form,"⁸¹ that "the category of shareholder-creditor is an unreal one,"⁸² that in "the economic sense the two relationships are practically identical."⁸³

The same approach to the characterization of ambiguous transactions may also serve to explain the results Hand reached in the *Fairfield Steamship* and *Transport Trading* cases. As he had in *Gregory*, Hand found, in those decisions, that the applicable Code provisions contained unstated requirements which the taxpayers had failed to meet. The difficulty with the opinions, however, is that the Code sections in question do not seem to entail the tax consequences which Hand approved.

80. *Alden Homes, Inc. v. Commissioner*, 33 T.C. 582, 598 (1959); *Clearview Apt. Co. v. Commissioner*, 25 T.C. 246, 254 (1955).

81. AMERICAN LAW INSTITUTE, *INCOME TAX PROBLEMS OF CORPORATIONS AND SHAREHOLDERS* 56 (1958).

82. *Id.* at 58.

83. Goldstein, *Corporate Indebtedness to Shareholders: "Thin Capitalization" and Related Problems*, 16 TAX L. REV. 1, 76 (1960). A shareholder-creditor would presumably satisfy Hand's "appreciable effect" test in any case in which there was a non-pro rata holding of debt and equity. "As the investment pattern moves further and further away from strict pro rata holding, the investor who holds a disproportionate amount of debt securities progressively loses his identity with the shareholder's interests. He is less likely to subordinate his debt . . . ; he is more likely to foreclose upon a default in interest payments; and he is less likely to agree to a reissuance of new debt when the old falls due." *Id.* at 7. The courts have also occasionally found an independent business purpose for the issuance of debt to a controlling shareholder, *Royalty Serv. Corp. v. United States*, 178 F. Supp. 216 (D. Mont. 1959), and of course the "genuine desire of the controlling shareholder to share with other creditors on liquidation may help to uphold the debt . . ." Goldstein, *supra*, at 24. It may be added that under Hand's approach, which normally would not involve a reclassification of the debt securities, a debt instrument held by a non-shareholder would be treated as such even though acquired from a controlling shareholder, so that, for example, interest paid to the outsider would be deductible by the corporation. See Bittker, *Thin Capitalization: Some Current Questions*, 34 TAXES 830, 835 (1956); cf. *R.C. Owen Co. v. United States*, 180 F. Supp. 369 (Ct. Cl. 1959), *cert. denied*, 363 U.S. 819 (1960).

On the other hand, the opinions do show that Hand was concerned with the character of the distribution itself, and not (as the Supreme Court was in *Court Holding* and *Cumberland*) with whether, in substance, the corporation or the shareholder had made the sale. His attention was on the transaction by which property was passed up from subsidiary to parent, and the question he sought to answer through analyses of the Code sections most nearly relating to that transaction was whether it was effective to avoid tax. But again, while the reorganization provisions were clearly at issue in *Gregory*, Sections 112(b)(6) and 115(a) do not appear to have had the same relevance in the later cases.

By contrast, the *Gilbert* test would treat the problem in those cases as one of sheer ambiguity. Assuming, as Hand found, that the decision to sell corporate assets to a known buyer at an agreed price had already been reached, the act of distributing the assets in advance of sale obviously could have had no appreciable, indeed no remote, effect on anyone's beneficial interest apart from taxes. This is not to imply that the taxpayer's choice of form was any more or less artificial than that made by the Commissioner; indeed they appear to be equal in that regard. The point, however, is, that lacking any reason to separate the distribution and sale, one is left to view those events as if they had occurred simultaneously. But once that is said, the characterization problem is entirely up for grabs and the question simply becomes one of choosing between the Commissioner and the taxpayer. It is precisely that choice which the *Gilbert* test purports to make—not, as in *Gregory*, by finding that a particular Code section contains additional unstated requirements, but by holding that where a transaction is otherwise ambiguous in character the burden is upon the taxpayer to resolve the ambiguity through a showing of comparative advantage. Accordingly, if the *Gilbert* rule had then been at Hand's disposal, an outcome favorable to the Commissioner would at least have been indicated and foreseeable in the *Fairfield Steamship* and *Transport Trading* cases.

The *Gilbert* rule is thus somewhat broader than the technique specifically employed by Hand in *Gregory*, and clearer, and it remains to consider how far and to what types of situations Hand intended that rule to extend. While one can do no more than guess at his intention on this score, it may be possible to get some idea of the range of his conception by enumerating the limitations on the scope of the business purpose requirement which he apparently thought it appropriate to accept from time to time. Of these the most important can fairly readily be inferred from the *Loewi* decision, from his conclusions

with respect to the tax definition of “debt” in *Gilbert* itself, and from his continued and unfailing regard for the status of the corporate entity.

As noted, Hand’s approach to the bad debt deduction in *Loewi* was quite literal. In *Gilbert*, although a bad debt deduction was also at issue, literalism was put aside. The two cases can be reconciled, however, on the ground that *Loewi* involved an act of forbearance on the taxpayer’s part, while *Gilbert* involved an overt transaction, *i.e.*, a distribution by the corporation purportedly in partial satisfaction of the taxpayer’s claims. The latter transaction, once found to be ambiguous in character, was subject to the appreciable effect test. But the same test could not be applied to mere delay in the disposition of an asset. Thus no conceivable rule authorizing the Commissioner to recharacterize ambiguous transactions could be pressed so far as to override the general Code requirement of realization, and no such rule can alter the fact that the tax law takes no account of paper gains and losses. An investor owning property which has appreciated or declined in value relative to its basis is always free either to postpone the recognition of gain or loss by retaining the property, or to occasion recognition by selling it. Hand evidently viewed the taxpayer-creditor in *Loewi* as in the same status and saw no reason to suppose that the taxpayer’s “privilege to liquidate his security” at a favorable time from the standpoint of tax benefit was any narrower than the privilege enjoyed by other investors—a position, incidentally, which found support in the Regulations relating to mortgage foreclosures.⁸⁴ In this sense, then, *Loewi* was a “realization” case and the decision merely illustrates an obvious and inescapable limitation on the scope of the business purpose doctrine, one which would apply no matter what that doctrine might be understood to mean.

Further, Hand’s willingness in *Gilbert* to say that the definition of “debt” for tax purposes is roughly coequal with its definition for nontax purposes suggests that in his view the Commissioner’s authority to disregard taxpayer choices also did not extend to the character or identity of an asset. Thus debt was “debt” whatever the taxpayer’s purpose may have been in constituting himself a creditor. As he pointed out in *Gilbert*, the *Gregory* doctrine does not permit the Commissioner to impute to the owner of tax-exempt municipal bonds the higher taxable return that might otherwise be received through the ownership of nonexempt securities. There may, in unusual cases, be some question

84. Treas. Reg. 118, § 39.23(k)-3(a) (1954), indicating that a bad debt deduction need not be taken by the mortgagee until the mortgaged property is sold.

as to whether a particular security belongs to the class of exempt issues; such a security must obviously possess certain identifying characteristics, and identification may occasionally present problems.⁸⁵ The point, however, is that the asset identification process stands apart from any further issue relating to the taxpayer's action in acquiring, retaining or disposing of the property once it is identified, and rarely if ever would the former involve a showing of business purpose.

In the same vein, Hand's unvarying respect for the corporate entity suggests that he did not consider an investor business purpose test to be a condition of jural personality under the tax law. A corporation which does business, which functions in more than nominal degree, is entitled to be recognized as a taxable person; the Commissioner lacks authority to assert that the same activity might equally as well have been carried on in another form or individually. Hand did of course insist that a "corporation" have some nontax goal, and in that sense business purpose was included among the identifying characteristics of the corporate entity for tax purposes.⁸⁶ But once the identification was made, nothing in the nature of an investor business purpose test could operate to deprive the corporation of its independent status under the tax laws. This is a point on which, despite *Higgins v. Smith*, Hand was never much in doubt; nor have the courts in general been especially uncertain about it. The Commissioner is still sometimes heard to con-

85. See, e.g., Lewis & Loftis, *The Tax Exempt Status of Local Government Bonds Used in Arbitrage Transactions*, 35 GEO. WASH. L. REV. 574, 578 (1967).

86. *National Investors Corp. v. Hoey*, 144 F.2d 466 (2d Cir. 1944). See also *Paymer v. Commissioner*, 150 F.2d 334 (2d Cir. 1945) (a corporation which did nothing except take title to the real estate conveyed to it was a sham to be disregarded for tax purposes). It should be emphasized that Hand's idea in *Gilbert* is by no means a substitute for what was done in *Gregory*; rather it adds a second and, in a sense, a subsequent level of analysis. Thus *Gregory* is relevant to an understanding of the definitional requirements of particular Code provisions because it authorizes a court to push beyond literal content and to restate those requirements in terms which reflect the legislative purpose. Once fully understood, however, and apart from considerations of estoppel, the statute should be applied even-handedly and without regard to whether it is the taxpayer or the Commissioner who seeks its application. But see *Commissioner v. State-Adams Corp.*, 283 F. 2d 395 (2d Cir. 1960), containing dictum to the contrary. *Gilbert*, on the other hand, has relevance to a case in which a given transaction fits equally well into alternative legal categories and the only problem is one of choosing between them. Hand's dissent would confine this choice to the Commissioner, but it would not authorize him either to disregard or to add to the existing requirements of any Code provision. He could not, for example, by invoking his discretion to choose between equivalent forms, insist that a transaction be viewed as a "reorganization" if any of the definitional elements of a "reorganization" were lacking, *Gallagher v. Commissioner*, 39 T.C. 144 (1962); nor could he, under the same authority, by adding conditions to the statutory definition find that an attempted "reorganization" had failed, *Bentsen v. Phinney*, 199 F. Supp. 363 (D.C. Tex. 1961). In short, nothing in Hand's scheme would empower the Commissioner to alter legal categories to fit transactions, and hence the latter's opportunity to recharacterize would be limited, generally, by the presence in the Code of provisions which define particular transactions in detail.

tend otherwise, notably in cases involving the division of an existing corporate enterprise,⁸⁷ but it is fair to say that on the whole the courts have not been persuaded to go beyond the relatively simple conditions laid down in *Moline Properties* and like decisions.

Another and possibly a final limitation on the application of the *Gilbert* principle is one which, though not directly expressed in anything Hand wrote, can perhaps be inferred from the fact that he conceived of the business purpose requirement, and largely applied it, in the context of dealings between corporations and their controlling shareholders. The suggestion—and it is not a new one⁸⁸—is that the Commissioner may lack authority to recharacterize transactions which take place between unrelated parties and which involve a negotiated price or other arm's length arrangement.⁸⁹ Thus, for example, the tax effect of using corporate funds to finance a shift of stock ownership between unrelated shareholders is apparently governed entirely by the taxpayers' choice of form. If a corporation owned equally by A and B redeems all of A's stock for cash, the result is a capital gain to A, the withdrawing shareholder,⁹⁰ while B, the continuing shareholder, is considered to have received no portion of the distribution despite the increase in his percentage ownership.⁹¹ Yet it is apparent that the same transaction could, in the alternative, be characterized either as (1) a payment by the corporation in satisfaction of B's obligation to purchase A's shares, in which event B would have a taxable dividend, or (2) a pro rata distribution to both shareholders with B using his portion to purchase all of A's shares, in which event A and B would each have a taxable dividend, with A's capital gain being cut in half. Presumably in this situation the taxpayer's beneficial interests are not appreciably affected, apart from taxes, by their choice of procedure; yet it is generally assumed,⁹² and the decided cases tend to confirm, that the

87. *Tillotson v. McCroxy*, 202 F. Supp. 925 (D. Neb. 1962). See also *Siegel v. Commissioner*, 45 T.C. 566 (1966).

88. Cf. Fuller, *Business Purpose, Sham Transactions and the Relation of Private Law to the Law of Taxation*, 37 TUL. L. REV. 355, 388-89 (1963).

89. There is of course no such inhibition when the question is one of appraisal or valuation, or depends upon some other factual determination. Thus, for example, a purported lease may be characterized as a purchase if the "lease" contains a purchase option or is renewable at a price which is less than the expected value of the property. *Starr's Estate v. Commissioner*, 274 F.2d 294 (9th Cir. 1959). Similarly, on the sale of a business, the Commissioner is not bound by the allocation of the purchase price among the assets sold, even though buyer and seller are unrelated, but "is free to increase or decrease the amounts so allocated in accordance with the facts." *Copperhead Coal Co. v. Commissioner*, 272 F.2d 45, 48 (6th Cir. 1959).

90. See *Zenz v. Quinlivan*, 213 F.2d 914 (6th Cir. 1954); Rev. Rul. 54-458, 1954-2 CUM. BULL. 167.

91. *Edenfield v. Commissioner*, 19 T.C. 13 (1952), *acquiesced in*, 1953-1 CUM. BULL. 3.

92. See B. BITTKER & J. EUSTICE, *supra* note 63, at 294-300.

Commissioner may not recharacterize a direct redemption of A's shares by insisting that the transaction could as well have been carried out in the form of a dividend to one or both of the parties. Since corporate-shareholder dealings are here present, the reason for the Commissioner's disability must be that the transaction is understood to represent an arm's length bargain between the shareholders with respect to the value of the withdrawing shareholder's interest, and is therefore properly to be regarded as an exchange.

Precisely why this factor of arm's length dealing should assure recognition of the taxpayer's choice of form is difficult to state, although of course in the case just given the policy of Code Section 302(b)(3) is powerfully suggestive, at least as to A. More generally, however, it may be, as the Tax Court has suggested in another context, that the law intends that unrelated parties shall be free to "determine their tax burdens inter sese" by extending their bargain to embrace the tax consequences.⁹³ This does not seem to mean that choice of form in arm's length dealings is always expected to produce a disadvantage to one party which is neatly offset by a corresponding advantage to the other, but it does suggest a realization that negotiations often take place against the background of an assumed set of tax consequences, and that these assumptions may be reflected in the terms, including price, on which the parties are finally able to agree. On the whole it seems not unreasonable for the Commissioner to be precluded from frustrating that agreement by redistributing the incidence of tax between the parties. This point seems especially strong where, as in the illustrative case, the possibilities for recharacterization are several and the Commissioner's choice might therefore bear more heavily on one party than the other.

Whether for these or other reasons, it is apparent that the *Gilbert* rule has its principal and perhaps its only application in the context of self-dealing. This limitation, however, would not exclude the fact situations in *Fairfield Steamship* and *Transport Trading*, nor indeed in *Gregory* itself, since all three cases, while an arm's length sale was ultimately in view, the transaction for which favorable tax consequences were specifically claimed was a distribution of property by a corporation to its sole shareholder. In these situations, as in *Gilbert*, the tax-determining transactions took place between related parties, were ambiguous, and hence created problems of characterization under the tax law. As stated, the *Gilbert* rule prescribes that the ambiguity may

93. *Foxman v. Commissioner*, 41 T.C. 535, 551 (1964).

always be resolved in the Commissioner's favor, despite the taxpayer's choice of form, unless the taxpayer can support his own characterization through a showing of independent economic advantage.

As a final observation on Hand's views in this area, it seems apparent, as stated, that he regarded the *Gilbert* principle as a one-way street, that is, as a rule authorizing the Commissioner either to bind the taxpayer by the form actually employed by him or to reject that form and put the taxpayer to his proofs. Such at least was the interpretation of *Higgins v. Smith* which Hand put forward in the *National Carbide* case, and it is a conclusion also strongly implied by the Supreme Court's decisions in *Smith* and *Burnet v. Commonwealth Improvement Co.* when those opinions are read together. Quite obviously, the weapon thereby placed in the Commissioner's hands is a powerful one. Presumably he can accept the form chosen by the taxpayer, as in *Commonwealth Improvement*; reject that form in favor of a higher-tax alternative, as in Hand's version of *Gilbert*; or take a middle ground and subject the transaction to a standard of reasonableness based on arm's length dealings, as he has always done in the case of salaries paid by a corporation to a shareholder-employee. All this, however, is perhaps less arbitrary than it appears to be, considering the limitations on the scope of the business purpose requirement described above. What it suggests is a perception that the Internal Revenue Code is in part a clumsy system of implied elections, of which some, such as the choice to do business in corporate form, are freely exercisable by the taxpayer and binding on the Commissioner, while others, notably those involving self-dealing transactions, are within the Commissioner's discretion to approve or reject.

To impute such a perception to Hand is of course to take great liberties with his occasional pronouncements on the subject of tax avoidance. On the other hand, it is plain that some sort of general restriction on choice of form was within his contemplation when he stated in *Gilbert*, as he had elsewhere, that "we cannot suppose that it was part of the purpose of the act to provide an escape from the liabilities that it sought to impose."⁹⁴ This statement, though it may be taken even more broadly than is suggested here, at least supports the inference that Hand thought it unlikely, and at any rate pointless and self-defeating, that Congress should have included in its principal taxing statute both high-tax and low-tax alternatives which the taxpayer, in his sole discretion, would be free to choose between at will.

94. 248 F.2d at 411.

When applied, as Hand applied it, to dealings between corporations and controlling shareholders, the *Gilbert* principle obviously strikes hard at a taxpayer's ability to reduce taxes by shifting capital funds in and out of corporate solution. For example, in addition to its effect on shareholder-owned indebtedness, Hand's beneficial interest test would readily extend to the purported sale of property by a sole shareholder to his corporation for cash. Since that transaction can as accurately be characterized as a contribution to capital and a concurrent cash distribution as it can a sale, the burden would be on the taxpayer to show that the status of seller had, or was expected by him to have, independent economic significance apart from taxes. An analysis of this sort, incidentally, would support the result in *Higgins v. Smith*, and it is perhaps notable that in citing *Smith* as authority for his approach in *Gilbert*, Hand for once appeared to be untroubled about "the differentia."⁹⁵

IV. Conclusion

Hand's decisions in *Gregory* and *Gilbert* represent complementary efforts to deal with a major problem of statutory interpretation in the tax field, *viz.*, when to accept the taxpayer's choice of form as determinative of his tax obligations. *Gregory* was a judgment in aid of rational tax administration. By rejecting literalism as a canon of construction, Hand's intention, and that of the Supreme Court, was apparently to limit tax avoidance to those situations in which the tax objectives sought by the taxpayer were not in plain opposition to those sought by Congress, at least as a judge might reasonably conceive of the latter. To this end the statutory definition of a reorganization was supplemented by

95. Presumably for the reason that its effect has been felt to be too sweeping and unconventional, the test that Hand proposed in *Gilbert* has had relatively little influence in the thin incorporation area to date. See *Nassau Lens Co. v. Commissioner*, 308 F.2d 39 (2d Cir. 1962). See also Goldstein, *supra* note 83, at 24. Its principal impact has been in the area of non-economic loan arrangements, in which an anticipated interest deduction is balanced off against a capital gain or in which an effort is made through the interest deduction to shift taxable income from one year to another. *Knetsch v. United States*, 364 U.S. 361 (1960); *Goldstein v. Commissioner*, 364 F.2d 734 (2d Cir. 1966). The courts, in general, have disallowed the interest deduction where the purported borrowing has no economic purpose apart from tax saving, and where the taxpayer would sustain a net economic loss on the transaction if taxes were disregarded. In the *Knetsch*-type situation the "lender" in effect collects a fee for serving as the taxpayer's nominal trading partner and for permitting the taxpayer to register an interest payment; in a clumsier era the same objective was sought through the medium of secret or tacit agreements. See *Du Pont v. Commissioner*, 118 F.2d 544 (3d Cir. 1941). It is perhaps notable that while in *Knetsch* the "lender" actively offered its services as an accommodation party, in the *Goldstein* case the lender was indifferent to and may even have been unaware of the taxpayer's objectives; yet the interest deduction was denied on the ground that the taxpayer lacked a non-tax purpose.

the additional requirement of business purpose. The decision showed that the Internal Revenue Code was to be interpreted in a free and liberal manner; accordingly, letter-compliance would sometimes be insufficient from the taxpayer's standpoint.

In application, however, the *Gregory* approach gave Hand (and the Court) some difficulty. In part, as Randolph Paul noted in commenting on the *Gregory* case, "the trouble with dependence upon free or liberal statutory interpretation of a taxing statute, is that no one can be sure when it will be employed."⁹⁶ Few now would quarrel with the effect of liberal interpretation in *Gregory* itself, but many indeed disputed its value in the *Transport Trading* case, while others criticized Hand's very failure to interpret liberally in *Loewi*. In the same way, the process of interpolating legislative purpose as a means of preventing tax avoidance proved unsatisfactory in the *Fairfield Steamship* case, Hand himself conceding in an addendum to the latter that his opinion "was elliptical and may cause confusion."⁹⁷ In the light of these difficulties his dissent in *Gilbert* suggests that he may have come at last to the view that the technique specifically employed in *Gregory*—that of broadening the statutory definition by adding "something not written there"⁹⁸—was inadequate to the needs of sound tax administration unless amplified. For the *Gilbert* dissent implies support for an interpretative principle of wider scope, one which deals directly and explicitly with the fundamental problem of taxpayer inventiveness in exploiting alternative forms and procedures, and does so by restricting the taxpayer's freedom to make an advantageous choice of form in a self-dealing context. It is a principle, also, which vests a very considerable, though not an unlimited, measure of discretion in the Commissioner, and in that respect perhaps reflects the approach taken by the Supreme Court in *Higgins v. Smith*.

Hand's response to the *Smith* decision over a period of years is again a reminder that his "penchant for logical statement" made it difficult but also imperative for him to deal frankly with the subject of tax avoidance and the problems of consistency in statutory interpretation. It was not enough, quite obviously, to say that the subject is one for which generalizations are useless, since that saying, like many another in the field, is ultimately an "anodyne for the pains of reasoning."⁹⁹ Hand was a sys-

96. R. PAUL, *supra* note 33, at 265; see Blum, *Knetsch v. United States: A Pronouncement On Tax Avoidance*, 1961 SUPREME COURT REVIEW 135, 145.

97. 157 F.2d at 323.

98. Rudick, *supra* note 47, at 255.

99. *Commissioner v. Sansome*, 60 F.2d 931, 933 (2d Cir. 1932).

tem-builder, whatever he may have declared to the contrary, and his contribution to the law of tax avoidance lay partly in his persistent effort to rationalize the administrative process. That effort, which certainly succeeded in some degree, is an important feature of our tax history; it seems not unlikely that it will be an element in our future as well.