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TAX AVOIDANCE

Alan Gunn*

Tax reduction is not evil if you do not do it evilly.
Murphy Logging Co. v. United States1
Away from here—that is my destination.
Franz Kafka2

This Article attempts an almost purely negative criticism. I contend that efforts to explain the results of tax cases not involving penalties by reference to “tax avoidance” are never satisfactory,3 whether the reference is meant to describe a taxpayer’s state of mind or to justify a tax rule by invoking some “need to prevent tax avoidance.” Because many tax problems are commonly discussed in terms of “tax avoidance” in one of these senses, and in order to avoid the impression that my arguments would leave the tax law in shambles, I shall suggest some alternative ways of dealing with these problems. But the positive aspects of the argument are intended only to illustrate that alternatives to “tax-avoidance” thinking are available, not to catalogue all of these alternatives, for that task would be unending.

Before dealing with the merits of “tax-avoidance” approaches to problems, it may be useful to consider, by way of an example, some different uses of the term “tax avoidance.” Suppose that the city of Metropolis imposes a wage tax on the earnings of those who work or reside there. Does this tax apply to someone who works outside the city but rents an apartment in the city to be close to city attractions?

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1. 378 F.2d 222, 223 (9th Cir. 1967).
3. My thesis as stated may be somewhat misleading. By “result” I mean only the answer to the question whether certain conduct should incur certain tax consequences. I do not mean to suggest that considerations of tax avoidance have absolutely no place in tax law. I consider it highly desirable, for instance, that those who draft general tax rules anticipate, and accommodate their rules to, possible tax-motivated responses. See text at note 11 infra.

By no means are tax laws uniquely subject to avoidance attempts; much of my discussion about taxation may have parallels in other fields. See generally Browder, Giving or Leaving—What Is a Will?, 75 MICH. L. REV. 845 (1977), which discusses cases invalidating inter vivos transfers not satisfying the formalities required for wills because the donor was trying to avoid leaving the property in question by will. Many other examples of “avoidance” of nontax laws are described in Note, Fraud on the Law—The Doctrine of Evasion, 42 COLUM. L. REV. 1015 (1942).

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Whenever required to give his address, the taxpayer uses that of his parents, who live outside Metropolis in a house where he rents a room, stores many of his possessions, and spends most weekends. What can people mean when they attempt to justify their opinion that the taxpayer should be subject to the city wage tax by referring to "tax avoidance"? They may mean that he must pay the tax because he maintains his suburban connections with the intent of avoiding that tax. Were this approach adopted by the taxing authorities, a taxpayer who behaved similarly but with a different motive would not be subject to the tax. Thus, one who maintained a suburban residence in order to vote against a loathsome suburban congressman or to use the suburban community swimming pool would not be taxed. If, however, the reason for imposing the wage tax on "residents" is that fairness requires those who benefit from city services to pay for them, this distinction is not very appealing. I doubt whether anyone would even raise the "tax-avoidance purpose" argument in extreme cases. For instance, if the taxpayer moved away from the city permanently because he disliked the tax, few would argue that his motive justifies continued liability.

Other people might make a "tax-avoidance" argument in support of taxing the earnings of our renter by asserting that a rule taxing such people "is needed to prevent tax avoidance." This argument need not refer to motive, since the person advancing it might well accept a rule taxing everyone who maintains an apartment in the city whatever his motives for claiming a residence elsewhere.

Those are the important uses of "tax avoidance," but other possibilities exist. For example, one might conclude, after analyzing the law of Metropolis, that the taxpayer who rented an apartment was clearly subject to the wage tax and was "avoiding" the tax by not paying it. Tax professionals call this "tax evasion." The distinction between "avoidance" and "evasion" is quite clear in principle, though not always in fact: one "evades" taxes by avoiding payment without avoiding liability, while one who avoids liability "avoids" the tax. "Tax avoidance" might also be used as shorthand for the suggestion that the law should be changed so that some who do not now pay a tax must in the future. Accordingly, some say that those who live on the interest from tax-exempt bonds are "avoiding taxes." This is simply an unpleasant and imprecise way of proposing that section 103 be repealed.

4. But cf. I.R.C. § 877 (a United States citizen who renounces citizenship to avoid taxes remains subject to tax on income from United States sources).

5. I.R.C. § 103.
Part I of this Article will examine cases that deny benefits to taxpayers on the ground that they entered into the transactions in question principally to reduce taxes. I shall discuss the extent to which this practice exists under a variety of guises and show that its principal drawback is not the practical problem of proving motive, as is sometimes supposed, but its inconsistency with customary ways of resolving tax cases. I shall then illustrate alternative means of dealing with “tax-avoidance” schemes and provide examples of unsatisfactory case and statute law resulting from “tax-motive” solutions. Part II will show that arguments characterizing certain rules of tax law as “needed to prevent tax avoidance” assert nothing more than that those rules are good rules. Using recent Supreme Court “assignment of income” cases as examples, I demonstrate that failure to appreciate this point produces unsatisfactory analysis. I argue that, although there is no reason why tax-motivated taxpayers should be treated differently from taxpayers with nontax motives, intelligent formulation of judicial and legislative rules requires that tax-motivated behavior be anticipated.

I. TAX-AVOIDANCE PURPOSE

A. The Problem

If the frequency with which a proposition appears in judicial opinions reliably measured its accuracy, nothing in the tax law would be more certain than the principle that the tax consequences of a transaction do not depend upon whether the transaction was undertaken to avoid taxes.6 The Supreme Court’s affirmation of that principle dates back at least to 1873, when it noted that a taxpayer had “the legal right” to avoid a tax on checks of twenty dollars or more by issuing two ten-dollar checks to a creditor.7 In Gregory v.

6. I except from this statement statutes that contain a tax-avoidance-purpose test, though one may suspect that the test actually used in applying those statutes involves something other than taxpayer purpose. Fuller, Business Purpose, Sham Transactions and the Relation of Private Law to the Law of Taxation, 37 Tul. L. Rev. 355, 391 (1963), points out that determinations under I.R.C. § 367(a)(1) (simply § 367 when Fuller wrote), which appears to require a purpose test, are made by the National Office, which “has no facilities for pursuing an inquiry into the subjective purposes of the taxpayer.”

7. United States v. Isham, 84 U.S. (17 Wall.) 496, 506 (1873). The statute in question in Isham imposed a stamp duty upon bank checks, drafts, and other specified instruments. Isham, the superintendent of a mining company, had issued unstamped scrip drawn on the company’s treasurer to pay employees. Thus, the taxpayer had issued an instrument fulfilling the function of those instruments which were required to have stamps but which differed in form. The Court held that a taxpayer has the right to use “devices to avoid the payment of duties” if the method chosen is “not illegal.” 84 U.S. (17 Wall.) at 506. In dictum, the Court hypothesized that a taxpayer would have “the legal right” to avoid a tax on checks of twenty dollars or more by issuing two ten-dollar checks to a creditor. 84 U.S. (17 Wall.) at 506. The Isham Court’s reliance on appearances to distinguish between taxable and nontaxable
Helvering, the leading "anti-tax-avoidance" case, the Court said, "The legal right of a taxpayer to decrease the amount of whatever otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted." Learned Hand's dissenting opinion in Commissioner v. Newman most forcefully states the doctrine:

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.

Is tax-avoidance purpose, which the courts have held "over and over again" to be irrelevant, even worth discussing? The answer is certainly "yes," if only because some have managed not to notice. The Carter Commission Report, for example, devotes a forty-two page appendix to "Problems of Tax Avoidance," nearly all of which concerns techniques for detecting taxpayers who enter into transactions to reduce taxes. Although the report discusses the American cases, including Gregory v. Helvering, with apparent approval, it skirts the question whether a tax-avoidance motive should even be relevant by flatly asserting that "motive would seem to be an essential element of tax avoidance" and that a taxpayer "who adopts one of several possible courses because that one will save him the most tax must be distinguished from the taxpayer who adopts the same course for business or personal reasons.”


8. 293 U.S. 465, 469 (1935). According to the Court, the issue was "whether what was done, apart from the tax motive, was the thing which the statute intended." 293 U.S. at 469. Judge Hand's opinion for the court of appeals said, "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 we chose, to evade, taxation." Helvering v. Gregory, 69 F.2d 809, 810 (2d Cir. 1934), affd., 293 U.S. 465 (1935).

For a more recent statement, see Knetsch v. United States, 364 U.S. 361, 365 (1960) ("We put aside a finding by the District Court that [the taxpayer's] 'only motive ... was to attempt to secure an interest deduction'" (footnote omitted)). More illustrations can easily be found. Most of the early cases rejecting tax-avoidance motive as a ground for determining tax liability are discussed in R. Paul, Restatement of the Law of Tax Avoidance, in STUDIES IN FEDERAL TAXATION 9 (1st ser. 1937).

9. 159 F.2d 848, 850-51 (2d Cir.) (dissenting opinion), cert. denied, 331 U.S. 859 (1947). Chirelstein, Learned Hand's Contribution to the Law of Tax Avoidance, 77 YALE L.J. 440, 456 (1968), calls this passage "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."

10. 3 REPORT OF THE ROYAL COMMISSION ON TAXATION: TAXATION OF INCOME (CANADA) 537-78 (1966).

11. Id. at 538 (emphasis added).
Those aware of the courts' repeated assertions sometimes suggest that the courts are not being candid. One writer describes statements like Learned Hand's as "pious protestations" which "simply cannot be the law under any circumstances." Another calls the maxim that people are free to reduce their taxes a "bromide," and a third calls it "perfectly true, perfectly general, and perfectly meaningless."

Cases can certainly be found which give good reason to believe, or which explicitly state, that the taxpayer lost because his principal purpose for engaging in a transaction was tax reduction. In *Brooke v. United States*, the Ninth Circuit said that "a transfer solely to avoid taxes will not be recognized." More often the opinions imply, without expressly admitting, that the court has been influenced by the presence or absence of a tax-avoidance purpose. In *Irvine K. Furman*, for instance, the Tax Court observed that the legal right to reduce one's taxes "is not dogma." Sometimes a description of a transaction as a "sham," accompanied by mention of a tax-avoidance motive, suggests that "sham" means nothing more to the writer than "a transaction entered into to reduce tax liability."


13. Bittker, *What Is "Business Purpose" in Reorganizations?*, in *New York University Eighth Annual Institute on Federal Taxation* 134, 137 (1950). Specifically, Professor Bittker argues that conditioning favorable taxation upon the existence of a nontax reason for the relevant transaction "does not undermine the bromide that a taxpayer is free to arrange his affairs so as to reduce his tax liability; it means only that the Treasury doesn't have to help him along." *Id.* at 137 (footnote omitted). But if the absence of any purpose other than tax avoidance does influence tax consequences, the taxpayer is not truly free to minimize his tax liability, unless we read the Court as adopting a sporting approach under which tax avoidance may be attempted but may not succeed if found out. The language in *Gregory v. Helvering*, 293 U.S. 465, 469 (1935) ("apart from the tax motive") and *Knetsch v. United States*, 364 U.S. 361, 365 (1960) ("We put aside a finding . . . that [the taxpayer's] 'only motive . . . was to attempt to secure an interest deduction'") can only mean that the Court considers the taxpayer's purpose a neutral fact in determining tax liability.

14. *R. Magill, Taxable Income* 164 n.57 (rev. ed. 1945). Magill is surely right if he means that the maxim does not tell us how cases should be decided, but it is at best misleading to describe as "meaningless" a principle that tells us how not to decide cases. Avoiding error surely furthers the pursuit of truth.

15. 468 F.2d 1155, 1158 (9th Cir. 1972). The court cited *Gregory* as support. With one dissent, the court accepted the district court's findings of several nontax motives for the transaction in question and so affirmed the decision for the taxpayer.

16. 45 T.C. 360, 364 (1966), *affd per curiam*, 381 F.2d 22 (5th Cir. 1967). *Furman* held that the trust in question should not be recognized for income tax purposes because of a "lack of economic reality." 45 T.C. at 366. The grantor of a trust retained a reversionary interest and denied the trustee any significant power. Indeed, the trustee (the grantor's wife) did nothing more "than passively acquiesce in [the grantor's] wishes." 45 T.C. at 364. The beneficiaries never acquired any beneficial interest, and none of the parties took the trust seriously except when filing tax returns.

17. *E.g.*, Rev. Rul. 76-255, 1976-2 C.B. 40, ruling that a temporary divorce obtained so that spouses can file as single taxpayers "should not be given any effect for Federal income tax
such an approach, a tax motive will be held against the taxpayer whenever the decision maker is inspired to call the transaction a “sham.”

Cases applying—or misapplying—the “business purpose doctrine” of *Gregory v. Helvering*\(^8\) also show the tendency of the courts to hold a tax-avoidance motive against the taxpayer. Although the Supreme Court denied that Mrs. Gregory’s tax motive was a reason for deciding the case against her, it described her transaction as “an operation having no business or corporate purpose.”\(^9\) If the tax success of a transaction depends on a business purpose, and if “business purpose” means what it seems to mean—a purpose other than that of reducing taxes—the principle that tax-avoidance purpose does not count against the taxpayer has been seriously undermined. The principle that transactions will not be ignored because entered into to reduce taxes means nothing if transactions entered into without a nontax reason will not be given effect.\(^20\)

The business-purpose

\(^{18}\) 293 U.S. 465 (1935).

\(^{19}\) 293 U.S. at 469. Although the Second Circuit also stated that it would not decide against Mrs. Gregory because of her tax motive, it similarly described her transaction as being “no part of the conduct of the business of either or both companies.” Helvering v. Gregory, 69 F.2d 809, 811 (2d Cir. 1934), aff’d, 293 U.S. 465 (1935).

\(^{20}\) Some of the cases imply that, although a strong tax motive will not invalidate an otherwise tax-favored transaction, a transaction entered into “solely” for tax avoidance will not be given effect. For example, in *Knetsch v. United States*, 364 U.S. 361, 366 (1960), the Supreme Court concluded that the transaction, from which the taxpayer could have realized “nothing of substance . . . beyond a tax deduction,” was a “sham.” One might suspect that the taxpayer in fact lost his deduction because tax avoidance was the sole purpose of the transaction. However, “sham” and “real” transactions cannot sensibly be differentiated according to a purported distinction between transactions inspired “solely” by tax reduction and transactions partially, but not exclusively, so inspired. Consider the facts of *Knetsch*. The taxpayer bought single-premium annuity contracts, borrowing the purchase price from the seller and prepaying interest. He then systematically borrowed the excess of the loan value of the contracts over his indebtedness. The only possible nontax benefits to the taxpayer were (1) an increase in the value of the contracts in the unlikely event of a precipitous fall in interest rates, see *Blum, Knetsch v. United States: A Pronouncement on Tax Avoidance*, 1961 Sup. CT. REV. 135, 150, and (2) the trivial annuity payments scheduled to begin thirty years after the purchase. One can reasonably assume that these nontax benefits played no part in Knetsch’s decision to buy the contracts. That does not mean, however, that Knetsch lacked a nontax purpose for buying them. By investing in one kind of tax shelter, the taxpayer necessarily decides not to invest in other tax shelters. Knetsch, for example, might have obtained tax benefits as impressive as those he hoped to get from his annuities by investing in an oil-drilling operation. If he considered such a venture but opted for less risky annuities, he had at least one nontax purpose for his transaction: to protect himself against the potentially ruinous losses sometimes incurred by oil investors. Every transaction necessarily involves foregoing other opportunities; thus, no transactions are entered into “solely” to reduce taxes. The distinction between solely and partially tax-motivated transactions is entirely imaginary and can be safely ignored.

That a transaction had no business purpose may occasionally be a useful finding, not because of a general rule that transactions without business purposes fail, but because the absence of a business purpose illuminates another important issue. For example, United States
doctrine is sensible to the extent that it means, as it seems to have meant in *Gregory*, that corporations must actually carry on business activities to be recognized as corporations under the reorganization provisions, though it might better be called the “business-effect” doctrine. But to go further and say, as the regulations and some shareholders with over 50% voting power may enter any number of arrangements that shift nominal voting power, but not actual control, to foreign shareholders, in order to avoid having a foreign corporation in which they own these shares labelled a “controlled foreign corporation” under § 957. The agreement may be that the foreign shareholders will withhold their votes or vote only as the United States shareholders dictate. Or United States shareholders may create and place in the hands of foreign shareholders a class of stock with only nominal voting power. Treas. Reg. §§ 1.957-1(b)(2) (1963) provides that the nominal voting power of that class of stock will be ignored in determining whether United States shareholders own more than 50% of the voting power of all classes of stock if three conditions are met. The third condition requires that “a principal purpose of the arrangement is to avoid the classification of such foreign corporation as a controlled foreign corporation under section 957.” This “business purpose” requirement makes sense, since the absence of any good business reason for creating a class of stock with nominal voting power suggests that the recipients of the stock may be puppets of the United States shareholders. Again, however, tax avoidance, or the absence of a business purpose, is relevant only as evidence. For more on the evidentiary use of tax avoidance motive, see text at note 41 infra.

21. Several courts and commentators have so interpreted the business purpose doctrine. See R. Magill, The Impact of Federal Taxes 133 (1943) (corporations “should live their lives, for a reasonable time at least, and should have something to do,” to be cognizable under the reorganization rules); Michaelson, “Business Purpose” and Tax-Free Reorganization, 61 Yale L.J. 14, 28 (1952) (“the *Gregory* case turned primarily on the permanence test”). See generally W. Andrews, Federal Income Taxation: Cases, Problems and Notes 826-28 (1969), which describes five possible interpretations of the *Gregory* opinion.

In *Lewis v. Commissioner*, 176 F.2d 646, 650 (1st Cir. 1949), Chief Judge Magruder described the new corporation in *Gregory* as “an evanescent creature.” He also rejected the taxpayers’ argument that in applying *Gregory’s* “business purpose” test to the transaction in question, a “corporate purpose” instead of a mere “shareholder purpose” is necessary.

In *Chisholm v. Commissioner*, 176 F.2d 646, 650 (1st Cir. 1949), Chief Judge Learned Hand said that the incorporator’s intent to avoid taxes in *Gregory* was “legally neutral” and that their plan failed because they had not “really meant to conduct a business by means of the two reorganized companies.” But see *Commissioner v. Transport Trading & Terminal Corp.*, 176 F.2d 570, 572 (2d Cir. 1949), cert. denied, 338 U.S. 955 (1950), where Judge Hand interpreted *Gregory* to mean that a tax provision pertinent to “commercial or industrial transactions” should not apply to “transactions entered upon for no other motive but to escape taxation.” B. Bittker & L. Stone, Federal Income Estate and Gift Taxation 739 (4th ed. 1972), notes the apparent inconsistency in these explanations of the significance of tax-avoidance motive.

Cf. Granite Trust Co. v. United States, 238 F.2d 670, 677-78 (1st Cir. 1956), where the court rejected the government’s argument that certain sales should be ignored because they transpired “between friends and for tax motives”.

To strike down these sales . . . would only tend to promote duplicity and result in extensive litigation. . . . It is no answer to argue that, under *Gregory v. Helvering*, there is an inescapable judicial duty to examine into the actuality of purported corporate reorganizations, for that was a special sort of transaction, whose bona fides could readily be ascertained by inquiring whether the ephemeral new corporation was in fact transacting business, or whether there was in fact a continuance of the proprietary interests under an altered corporate form.

22. E.g., Treas. Reg. § 1.368-1(b) (1960), providing that the reorganization provisions exempt from the general rule of recognition of gain or loss on exchanges of property only “such readjustments of corporate structures . . . as are required by business exigencies.” Treas. Reg. § 1.368-1(c) (1960) states that a transaction “the object and accomplishment of which is
cases do, that a transaction must be entered into for a business reason (or even a "corporate" as distinct from "shareholder" business reason), is to say that in those areas of the tax law to which the business-purpose doctrine applies, a strong tax motive is fatal to the transaction despite the Supreme Court’s assurance otherwise in the case that created the doctrine.

The strained and unsatisfactory statutory interpretations used in gift-and-leaseback cases to strike down tax-motivated transactions illustrate further the practical importance of tax-avoidance purpose in deciding cases. In the typical gift-leaseback case, an owner of business property, often a doctor who owns his office building, gives the property to a trust and specifies his dependents or other close relatives as beneficiaries. He then rents the building from the trust, which he has carefully designed so that its income will not be taxed to him under the grantor trust provisions of the code. The doctor plainly wants a section 162 business expense deduction for the rent at the cost of the rent money, which remains in the family.

Many cases deny the section 162 deduction in the gift-leaseback situation. Courts commonly hold that the rental payments were not, as section 162 requires, "made as a condition to the continued use for purposes of the trade or business," since the rental obliga-

23. E.g., Elko Realty Co., 29 T.C. 1012, 1026, aff’d per curiam, 260 F.2d 949 (3d Cir. 1958); J.D. & A.B. Spreckles Co., 41 B.T.A. 370, 374 (1940) (corporations whose acquisition "does not serve a business purpose, as distinguished from a tax-reducing purpose" are not affiliates under the consolidated-return regulations).


25. Although the business-purpose doctrine originated in the corporate reorganization context, it has spread to several other areas. See Basic Inc. v. United States, 549 F.2d 740, 749 (1977) (dissenting opinion) ("since its genesis in the context of corporate reorganizations, the doctrine of Gregory has enlisted such a following that an inquiry into whether the substance of a transaction corresponds to its form is now appropriate in every area of tax law"); Summers, A Critique of the Business-Purpose Doctrine, 41 Ore. L. Rev. 38, 43 (1961). The doctrine's tendency to wander into new fields has occasionally been checked. E.g., United States v. Davis, 397 U.S. 301, 312 (1970), which held that the lower court was "wrong in looking for a business purpose and considering it in deciding whether [a] redemption was equivalent to a dividend" under § 302(b)(1).

26. But see [1978] Stand. Fed. Tax Rep. (CCH) ¶ 1382.07, at 17,295, which says that "financial and professional reasons" induce taxpayers to transfer business property to a trust and lease it back, and notes almost in passing that "these transactions also bring with them some tax advantages." The "financial and professional reasons" given (the possible interest conflict inherent in a physician's ownership of both a medical practice and an adjoining pharmacy, and a professional's desire for working capital) are both absurd. Everyone knows that gift-leaseback deals are heavily tax-inspired.

tion grew from a "personal" decision to transfer the property to the trust. In effect, those courts answer the question whether a rental payment is a business expense by determining whether the transaction giving rise to the rental obligation was a business transaction, rather than by determining whether the rental property was used for a business purpose. According to this analysis a taxpayer who signed a long-term lease intending to use the property for personal purposes, but who later used it in a business, would be denied a rental deduction. That result is patently unsatisfactory.

A few courts deny rental deductions in the gift-leaseback cases where the taxpayer retains a reversionary interest in the trust on the ground that he has an "equity" in the property within the meaning of section 162(a)(3), which allows the deduction only if the taxpayer "has no equity" in the property. But the Tax Court convincingly rejected that interpretation of the "no equity" requirement in Mathews v. Commissioner. Although the court found no useful legislative history, it concluded that according to common sense section 162(a)(3) should be read to disallow current deductions for a "capitalizable item" but to allow a rental deduction when the rental payments are not appropriate additions to basis. The statutory

28. See, e.g., Perry v. United States, 520 F.2d 235, 237-38 (4th Cir. 1975), cert. denied, 423 U.S. 1052 (1976); Van Zandt v. Commissioner, 341 F.2d 440, 443 (5th Cir.), cert. denied, 382 U.S. 814 (1965); Butler v. Commissioner, 65 T.C. 327, 329-30 (1975). Contra, Brown v. Commissioner, 180 F.2d 926, 929 (3d Cir.), cert. denied, 340 U.S. 814 (1950); Skemp v. Commissioner, 168 F.2d 598, 600 (7th Cir. 1948); Engel v. United States, 400 F. Supp. 5 (W.D. Pa. 1975); Alden B. Oaks, 44 T.C. 524, 532 (1965). For the purpose of applying the business-purpose test, the Tax Court at least distinguishes between gift-and-leaseback agreements where the leaseback is "prearranged" (in that it is arranged at the inception of the trust and the trustee may never exercise independent discretion whether to lease back to the grantor) and agreements where the trustee has such discretion even though the leaseback to the grantor is agreed upon at the trust's inception. Compare Butler v. Commissioner, supra (if the trustee incurs the obligation to lease back to the grantor as a condition of transfer, then the gift and leaseback are a "single, integrated transaction" and no rental deduction is allowed unless a business purpose exists for the initial transfer) with Mathews v. Commissioner, 61 T.C. 12 (1973), revd on other grounds, 520 F.2d 323 (5th Cir. 1975), cert. denied, 424 U.S. 967 (1976) (if trustee has independent discretion whether to lease back to grantor, then only the leaseback, as distinguished from the initial gift transfer, must have a business purpose to qualify for a rental deduction). Long before Butler and Mathews, Froehlich, Clifford Trusts: Use of Partnership Interests as Corpus; Leaseback Arrangements, 52 CALIF. L. REV. 956, 970 (1964), argued that that distinction is artificial and of little practical importance since the grantor has every incentive to be the highest bidder for the property even if the trustee can lease it to anyone.


30. 61 T.C. 12 (1973), revd on other grounds, 520 F.2d 323 (5th Cir. 1975), cert. denied, 424 U.S. 967 (1976).

31. Oliver, Income Tax Aspects of Gifts and Leasebacks of Business Property in Trust, 51 CORNELL L.Q. 21, 37-39 (1965), discusses and rejects the idea that only the amount of the rent less the annual increase in the value of the grantor's reversionary interest should be deductible, since only that amount is the real cost to the grantor.
language could be read to mean just the opposite, for it requires that the taxpayer "have" no equity, not that he not be acquiring one. This rather technical reading can be easily refuted, however, by saying that the "property" the taxpayer rents is the present interest, not the reversionary interest. The taxpayer has no equity in that. As the Mathews opinion notes, it would be absurd to deny a rental deduction simply because the taxpayer owns some interest other than the interest being rented in the building. Absent a clear tax-avoidance purpose, the courts would surely not deny the deduction, for instance, to one co-tenant who rented the other's interest or to a remainderman who rented the life tenant's interest. The only reasonable conclusion to be drawn from the unconvincing analyses of section 162(a) in many of the gift-leaseback cases is that the taxpayers' obvious tax motives were the real reason for the government's victories.

32. 61 T.C. at 23.
33. 61 T.C. at 22-23. See Froehlich, supra note 28, at 976:

It is submitted that the view taken by the courts in the lease-option cases is the correct interpretation of "equity" in section 162(a). It is entirely reasonable to preclude deductibility of a payment which is not for the temporary "use" of property, but in reality is adding to ownership equity. On the other hand, there is no justifiable reason for summarily preventing the rental of property by a person who happens to have an ownership interest in the property other than his leasehold interest. Such a rule would preclude not only the rental of property donated to a short term trust, and the rental of property subject to an option to purchase, but other practical and honestly conceived business transactions.

For instance, is there any reason to prevent the lessor of a master supermarket lease from being a subtenant of the lessee in the supermarket liquor department? Should a vested remainderman be prevented from renting from the life tenant? Suppose a vendee desires to take possession of premises prior to the close of escrow. Is there any policy justification for denying deductibility to the rental payments made for the short term business lease arranged so as to allow early occupancy? The answer to all these questions must be "no."

It is suggested, therefore, that the recent literal interpretation of "equity" made in the referenced leaseback cases is not correct, and that it should be rejected.

34. The main substantive reason given by the courts for denying the rental deduction in many of the leaseback cases is that the arrangement diverts some of the taxpayer's income. E.g., Van Zandt v. Commissioner, 341 F.2d 440, 443 (5th Cir.), cert. denied, 382 U.S. 814 (1965). That is true, but not a persuasive reason for denying a deduction absent some important reason for distinguishing between an assignment by way of a trust of an income interest in an office building leased to a stranger and a similar assignment of a similar interest in a building leased to the grantor. See Engel v. United States, 400 F. Supp. 5, 5-6 (W.D. Pa. 1975):

[H]ad the trustee of the property conveyed by plaintiff to the Clifford trust rented out this property to a third-party while the plaintiff rented similar premises on the open market for the same rent, the tax consequences would be the same as the result here if the plaintiff's deduction is upheld. Any reduction of the plaintiffs' taxes which resulted from this packaged business arrangement has been sanctioned by Congress in Sections 671-79. The court may have overstated the case in its last sentence. S. REP. No. 1622, 83d Cong., 2d Sess. 365, reprinted in [1954] U.S. CODE CONG. & AD. NEWS 5006, states that I.R.C. §§ 671-79 have "no application in determining the right of a grantor to deductions for payments to a trust under a transfer and leaseback arrangement." Since this history expressly leaves the development of the gift-and-leaseback law to the courts, it is technically incorrect to say that Congress has "sanctioned" this form of tax reduction. Nevertheless, the court's result and reasoning are sound. Since there is no economic difference between the assignments of income permitted under the grantor trust provisions and those involved in a transfer and lease-
B. The Difficulties of Proving Motive

Many argue that tax-avoidance purpose should be irrelevant to the determination of tax liability because of the difficulties of proving the taxpayer's motive. This argument certainly has some merit: motive can be hard to prove and factfinders apparently hesitate to find a tax-avoidance motive even in the face of compelling evidence. This is reason enough to avoid motive tests if alternatives exist, for if only a taxpayer's admission will compel a finding of tax motive, the denial of tax benefits on the basis of motive in effect imposes a tax on candor. Suppose a doctor plans to incorporate his practice in order to obtain the benefits of a qualified corporate pension plan. The Internal Revenue Service will not rule on transactions which "have as their principal purpose the reduction of Federal taxes," and without a ruling the taxpayer cannot be assured that the transfer of his accounts receivable to the corporation will not be a taxable event. What is the taxpayer to do? The accepted prac-


36. The difficulty of showing tax motive proves very little, however, for it goes only to technique, not to the fundamental question whether a tax-reduction motive should matter. An advocate of tax-motive tests who recognizes their serious administrative problems might favor rules not specifically employing motive tests but designed to detect those likely to have been inspired by thoughts of tax-saving. In any event, proving motive may be less difficult than is sometimes thought. Leading "anti-tax-avoidance" cases such as Gregory and Knetsch v. United States, 364 U.S. 361 (1960), involved transactions that no sensible person would have entered into but for tax savings.

37. Treas. Reg. § 601.201(e)(2), 1972-1 C.B. 701, requires a taxpayer requesting a ruling or determination letter to submit a "complete statement of all relevant facts," including a "full and precise statement of the business reasons for the transaction." Rev. Proc. 72-9, 1972-1 C.B. 719-20, provides that the Service will not issue rulings or determination letters concerning "[t]he results of transactions which lack bona fide business purpose or have as their principal purpose the reduction of Federal taxes." Rev. Proc. 73-10, 1973-1 C.B. 760, 762, a "convenient checklist questionnaire" for rulings under I.R.C. § 351, demands an explanation of "the business reasons for the transaction."

38. The transfer of property "to a corporation by one or more persons solely in exchange for stock or securities in such corporation" will not result in a recognizable gain or loss if "immediately after the exchange such person or persons are in control . . . of the corporation." I.R.C. § 351. The hypothetical doctor who plans to incorporate will want to ascertain that the accounts receivable he transfers to the corporation are "property" under § 351. A transfer of receivables could be considered an assignment of income by the doctor to the corporation. See generally Brown, Incorporating Transfers and Anticipatory Assignments, 38 U. Pri. L. Rev. 589 (1977). In that case, either the doctor might be taxed on the receivables the corporation collects, or the receivables might be held not to be "property" under § 351, and the doctor would be forced to recognize any gain or loss on the transfer. One taxpayer's argument that receivables are not "property" under § 351 was rejected in Hempt Bros., Inc. v. United States, 354 F. Supp. 1172 (M.D. Pa. 1973), affd., 490 F.2d 1172 (3d Cir.), cert. denied, 419 U.S. 826 (1974). The problem of accounts receivable and the related problem of transfers of accounts payable are discussed in Kahn & Oesterle, A Definition of "Liabilities" in Internal Reve-
tice, as I understand it, is to lie; the taxpayer solemnly asserts in his ruling request that he is incorporating the practice for the “business purpose” of obtaining the “efficiency” of corporate operation. The lie in this process can fairly be called a legal fiction, for it deceives nobody; and it should be unnecessary, for several cases say that a corporation formed for tax reasons will be recognized if it actually carries on business. But this example merely shows that people should not be asked to deny their tax motives where tax motive is irrelevant. If good reasons exist to deny tax benefits to those who want them badly, those reasons might support taxing such people whenever they can be detected, even though others may escape. We do not repeal laws against mugging just because most muggers cannot be caught.

Other arguments for the irrelevance of tax-avoidance purpose proceed on the wholly erroneous notion that the tax consequences of transactions can be determined “objectively,” that is, from facts other than those bearing on motive. Only a very crude tax system could function, however, without taking into account the reasons behind actions. The importance of motive in the decision of even routine cases is commonly overlooked only because motives are usually clear. Consider a taxpayer who buys a house for $50,000, lives in it

39. See Moline Properties, Inc. v. Commissioner, 319 U.S. 436, 439 (1943) (“So long as [the reason for organizing the corporation] is the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity” (dictum) (emphasis added)); National Investors Corp. v. Hoey, 144 F.2d 466, 468 (2d Cir. 1944) (“to be a separate juridical person for purposes of taxation, a corporation must engage in some industrial, commercial, or other activity besides avoiding taxation”); Ross Glove Co. v. Commissioner, 60 T.C. 569, 588 (1973) (“If [the corporation] was organized for and engaged in substantial business activity, it will be recognized for tax purposes . . . . The fact that tax motivations involved in the formation of [the corporation] is not a basis for ignoring what is otherwise a viable business entity” (citation omitted)); Nat Harrison Assocs., Inc., 42 T.C. 601, 618 (1964); Aldon Homes, Inc. 33 T.C. 582, 596-97 (1959).

40. E.g., Angell, Tax Evasion and Tax Avoidance, 38 Colum. L. Rev. 80, 82-83 (1938) (with “one or two exceptions,” tax questions turn “entirely upon objective facts”). See Sutherland, Taxpayers’ Motive as a Basis for Taxability, in NEW YORK UNIVERSITY EIGHTH ANNUAL INSTITUTE ON FEDERAL TAXATION 990 (1950) (though taxpayer intent often matters, it should be irrelevant except in the few instances where Congress has made tax liability depend on motive in order to correct particular abuses).

By “motive” and “purpose” (here used interchangeably) I refer to the reasons people act. These words overlap to a considerable extent, though not completely, with “intent.” The great differences some find between “motive” and “purpose” are insubstantial for purposes of this Article; using these words as synonyms will confuse no one.
for a few years, and sells it in 1978 for $50,000. The taxpayer appears to have neither gained nor lost, and both his and his buyer's motives seem unimportant. If, however, the buyer was the taxpayer's employer and similar houses were selling in 1978 for $30,000, the need to inquire into the reasons for the $50,000 payment becomes apparent: the employee may intend to disguise $20,000 of payment for services as part of the sale price of his house. If the buyer had been a stranger, the transaction would have been taken at face value, not because motive is irrelevant but because it would have been clear. Many other examples exist. Suppose the "objective facts" of a transaction are that A wrote a check for $1000, payable to B, who then cashed the check. We cannot even guess at the tax consequences of this transaction without knowing A's motive.

In some cases, the courts definitely should consider a showing of tax-avoidance motive, not because tax-motivated transactions should automatically fail, but because the tax motive sheds light on something else. Suppose a taxpayer offered a lawyer $5,000 to pursue a tax refund claim and $2,000 to sue to enjoin a neighborhood nuisance. A factfinder confident that the taxpayer knew nothing of section 212(3), which allows a deduction for expenses incurred "in connection with the . . . refund of any tax," would allow a deduction of $5,000. We would expect a different result, however, after a showing that the taxpayer originally offered the lawyer $2,000 to pursue the refund claim and $5,000 to enjoin the nuisance but reversed the offers after learning about the deductibility of legal fees. Cases like this suggest that labelling tax-avoidance motive "neutral" overstates the matter, but they do not even tend to show that tax-motivated transactions should fail ipso facto. Indeed, proof of a tax reduction motive benefits the taxpayer in some cases. For example, where it is unclear whether a bequest qualifies for the estate tax marital deduction, evidence that a decedent tried to fit the bequest within the provision supports the argument in favor of granting the deduction.41

C. The "Explanation" That Does Not Explain

The real case against tax-avoidance-purpose tests does not rest upon the administrative hardships involved in establishing motive, but upon the commonplace observation that most transactions are taxed without regard to the presence or absence of a tax motive.42

41. See, e.g., Estate of Neugass v. Commissioner, 555 F.2d 322 (2d Cir. 1977).
42. The textual statement must be qualified. As shown in note 47 infra, administrative impossibility is at least one reason the majority of transactions cannot be taxed according to
High-income taxpayers forego opportunities to earn additional income for tax reasons. Taxpayers often sell depreciated assets when the loss will most benefit their tax status. Other taxpayers live on tax-exempt interest. All of them may openly admit their tax motivations without jeopardizing those transactions. This alone shows that careful tax planning cannot by itself be the basic explanation for cases denying some tax-motivated taxpayers the benefits they sought; it fails to explain why a normally unimportant fact becomes basic in a particular case.

The unimportance of tax motive in most cases does not by itself prove that tax motive should never be important; tax-motive tests could be appropriate in particular kinds of transactions even though inappropriate generally. But I cannot think of any good examples, and the best attempt I have found falls short. The Carter Commission Report, which at least recognizes the problem, tries to distinguish the cases where tax motive matters from those in which it does not:

If a man gives up the right to income and to any control over the income or the source of income, even with the avowed purpose of reducing his tax liability, he should not be taxed on that income. However, if he contrives matters in such a way that he continues to enjoy the benefits of income, or if he continues to control the source or disposition of income, he should not be allowed to reduce his liability below what a taxpayer in similar circumstances receiving the income would normally expect to pay under the tax system.\footnote{3 REPORT OF THE ROYAL COMMISSION ON TAXATION: TAXATION OF INCOME (CANADA) 542-43 (1966).}

This passage distinguishes reasonably well between cases in which one is taxed on income not received and cases in which one is not. But it does not show that in cases where the taxpayer "continues to enjoy the benefits of income, or . . . the source of disposition of income" a tax motive for retaining the continuing interest justifies continued taxation, while some other motive does not. This point can be clarified by considering the problem not as one of taxing people who have tried to avoid taxation but rather as one of not taxing people who have not tried to avoid taxation.\footnote{4 The problem of \textit{Gregory}, for example, is not really whether Mrs. Gregory should be taxed as if she had received dividends; of course she should. The question is whether another taxpayer who performs the same transaction for a different reason should not be taxed. What is the liability, for instance, of one who performs such a transaction to avoid a peculiar local law that allows only indirect dividend distribution? Phrasing the problem this way may help overcome fuzzy moralistic notions that all tax reduction attempts are bad. To be sure, the great majority of cases striking down artificial schemes differing in some trivial way from what the taxpayer would have done "but for taxes." The administrative-difficulty argument I criticize here concedes the theoretical desirability of taxing tax-avoiders heavily but argues that problems of proof in individual cases make such a test impractical.}

Control over the dis-
position of income is an excellent reason for taxing the person who has that control and who has given up the right to receive the income for tax reasons. This is true because control is a sensible basis for choosing the person taxable on the income. Thus, good reason exists to tax one who has given up the right to receipt and kept the right of control for a reason entirely unrelated to taxation, such as a desire to benefit a relative combined with a distrust of that relative’s competence to manage income-producing property.

The inadequacy of any attempt to explain cases by references to the taxpayer’s tax-reduction motive manifests itself in a plainly ridiculous statement: “Tax reduction is not evil if you do not do it evilly.” This “rule” so obviously begs the question that no one, doubtless including the court that made the quip, would seriously argue that it explains anything. Yet those who insist that a tax motivation justifies denying a taxpayer some benefit assert this very “rule” if they concede, as they must, that tax motive is often irrelevant.

plainly taxable transactions will involve tax-motivated taxpayers, for only such taxpayers will have the incentive to arrange those schemes. Those who jump from this obvious point to the conclusion that taxpayers lose because they are tax-motivated fall victim to the “post hoc ergo propter hoc” fallacy.

See also Frank Lyon Co. v. United States, 435 U.S. 561, 584 (1978), where Justice Blackmun, in an opinion upholding a transaction motivated in significant part by tax considerations, said that a transaction “not shaped solely by tax avoidance features that have meaningless labels attached” should be taken at face value. This statement implies that transactions shaped by “tax avoidance features that have meaningless labels attached” need not be treated as the parties had hoped. This is sound enough as far as it goes, but what does the reference to “tax avoidance features” add? It may be wise to disregard “meaningless labels,” whatever the reason they were attached. Neither Justice Blackmun nor, so far as I am aware, anyone else, has ever justified disregarding tax-inspired “meaningless labels” while deferring to “meaningless labels” attached for nontax reasons. For the most part, Lyon Co. does not focus on the parties’ tax motives or lack thereof. Instead, the Court examined a leaseback transaction to determine whether the taxpayer, who had title to the building in question, was in economic reality the owner of the building. The Court seems at least to have asked the right question, whatever one may think of its answer.

It may be worth noting at this point that not all tax questions can or should be resolved by trying to determine the “substance” of the transaction, as opposed to its “form.” There are many cases (those involving elections are illustrative) in which formalities do and should control. See generally Schaffer, Another Guideline to the Rule of Form in the Taxation of Corporate Transactions, 56 Taxes 160 (1978), which notes a number of cases in which observation of formalities does not subvert the purpose of the provision in question because no discernible purpose can be found.

45. See, e.g., Lucas v. Earl, 281 U.S. 111, 115 (1930), the first “assignment of income” case. The assignment in question had been made in 1901 and thus could not conceivably have been tax-inspired.

46. Murphy Logging Co. v. United States, 378 F.2d 222, 223 (9th Cir. 1967). A more elegant but similarly vacuous rule is provided in Income Tax Act, 1971, c. 63, § 246(1)(Can.), which authorizes ignoring a transaction having a principal purpose of “improper” tax avoidance.
D. Hard Cases

I have argued that one cannot justify the use of tax-motive tests without distinguishing the cases in which those tests should be applied from the many cases in which they should not. In this section, I argue that no such distinction can be found. Admittedly, I cannot prove this conclusively without analyzing every possible tax problem to show that the proper solution to each does not depend upon the presence of a tax motive, a task I am not prepared to undertake. But a consideration of the types of cases which commonly offer tax-motive explanations and of the usual ways of resolving those cases strongly suggests, if it does not prove, that tax-motive tests are inconsistent with conventional ways of deciding hard cases.

Even in principle, one would use a tax-motive test only in close cases, those in which one wonders whether "what was done... was the thing which the statute intended." The transactions in Gregory

47. The idea that all taxpayer behavior could be subject to a "non-tax purpose" requirement is preposterous. Consider, for example, the inevitable failure of combating estate tax "avoidance" by levying on all estates the tax they would have incurred had the decedent not acted to reduce taxes. Even if the decedent could tell the tale, he could not in any but the simplest cases say how he would have left his property if there had been no estate taxes. Had Mrs. Gregory's tax advisers been more prescient, she could have easily avoided the dividend tax by doing nothing (assuming there were no accumulated-earnings tax or personal holding-company tax problems). Problems of proof alone show that any rule directed against tax-motivated activity must in practice aim only at tax-motivated activity closely resembling transactions taxed less favorably. Once the problem is limited in that way, one may legitimately ask whether ignoring those differences is better justified by the resemblance to the heavily taxed transaction or by the tax motive for whatever incidental differences exist.

It is intriguing, though perhaps not very profitable, to speculate about the astonishing attractiveness to so many people of the idea that the schemes of Mrs. Gregory, Mr. Knetsch, and others failed because of their tax motives. I suspect that some find simplicity in this explanation, which seems to make irrelevant difficult questions about the purposes of and assumptions behind the statutes in question and the propriety of stretching the statutes beyond their "plain meaning." But the appearance of simplicity is deceptive, unless one stops thinking as soon as the particular case under consideration has been resolved. A rule that tax-inspired events will be disregarded may seem to explain Gregory, but it does so by making incomprehensible the much greater number of cases in which a tax motive is irrelevant. The "rule" against tax-motivated transactions accurately describes current law only if the rule is limited to "improper" avoidance, and that limitation raises all the difficulties sought to be resolved by the apparently simple rule.

48. Gregory v. Helvering, 293 U.S. 465, 469 (1935). The most common case of a transaction which is literally covered by a statute but which is not "the thing which the statute intended" occurs where the statute describes characteristics of a transaction to be taxed in a certain way and where, while the actual transaction has all of those characteristics, it serves a function different from that of transactions the statute was meant to cover. The reorganization provisions, for example, are meant to facilitate the rearrangement of corporate structures, but the statute never mentions this; instead, it describes sets of events, the occurrence of which are defined as "reorganizations" of one sort or another. From this divergence of statutory purpose (facilitating or impeding conduct directed toward certain goals) from statutory technique (description of the features of transactions) grows the need for imaginative statutory construction. The problem is probably caused by an assumption that statutes should define and that definitions are detailed lists of the features of the things defined. Cf. C. Dickens, Hard Times 7 (1st ed. London 1854):
Tax Avoidance, for example, seemed to be those that the reorganization provisions describe. In effect, however, the shareholder received an asset previously owned by her corporation—the taxpayer received a dividend. The question was whether the events should be taxed under the rules regarding dividends or under those regarding reorganizations. Had the transaction not resembled both a dividend and a reorganization, the case would have been simple: a straightforward distribution of the property as a dividend would have been taxed as a dividend, and an unequivocal reorganization would not have been taxed. Thus, resolving the case required classifying an ambiguous transaction having both dividend and spin-off features. This kind of problem can only be resolved by deciding whether the transaction, in its important aspects, was more like a dividend than like a reorganization. Of course this resolution cannot be accomplished merely by comparing the number of dividend features with the number of reorganization features. Faced with a case like Gregory, a court must decide, for example, whether one or the other classification will serve the purposes of the reorganization and dividend provisions; whether the language of the statute can support dividend or reorganization treatment or both; and whether a particular result will serve administrative convenience while protecting those who planned complex transactions in reliance on the apparent meaning of the statutory language. This is not an easy process and certainly cannot be reduced to a formula, particularly when some of these considerations support one result and some the other. Since an intent to reduce taxes is irrelevant in clear cases—those in which

“Bitzer,” said Thomas Gradgrind. “Your definition of a horse.”

“Quadruped. Graminivorous. Forty teeth, namely twenty-four grinders, four eye-teeth, and twelve incisive. Sheds coat in the spring; in marshy countries, sheds hoofs, too. Hoofs hard, but requiring to be shod with iron. Age known by marks in mouth.” Thus (and much more) Bitzer.

“Now girl number twenty,” said Mr. Gradgrind. “You know what a horse is.”

I suspect that statutes drafted with explicit reference to the effects of transactions covered could be sensibly interpreted without causing concern about “judicial lawmaking,” and that such statutes would need much less frequent legislative repair than statutes of the ordinary type. But I cannot enlarge on this subject here.

49. Except for the extreme cases in which the taxpayer runs afoul of the accumulated-earnings tax or the personal holding-company tax, I know of no case in which the government has even argued that a taxpayer in control of a corporation is not free to declare dividends at whatever time best suits him. That assumes, of course, that a purported “dividend” is not in substance something else, such as part of the purchase price of corporate stock, as in Waterman S.S. Corp. v. Commissioner, 430 F.2d 1185 (5th Cir. 1970), cert. denied, 401 U.S. 939 (1971).

50. Careful tax planning, which usually involves a ruling, is the routine practice of taxpayers who want to ascertain whether a transaction qualifies as a reorganization.

51. Every tax provision I know of aims at one of two goals: (1) obtaining a satisfactory practical determination of net income, which is commonly thought to be an accurate measure of “ability to pay,” or (2) encouraging some activity. Denying benefits to people who try to
the facts may be easily characterized—one cannot decide which description a transaction more closely resembles by asking whether it was entered into to reduce taxes. The question is whether a transaction more resembles X than Y; if the definition of neither X nor Y includes terms of tax-avoidance purpose, how can the intermediate case sensibly be classified by deciding whether it involves a tax-avoidance purpose?

Many decisions commonly viewed as turning upon a tax-reduction motive have reached satisfactory results. If we wish to preserve those results while rejecting the tax-motive explanations, we must find alternative justifications. Since even the courts that claim not to have been influenced by a strong tax motive sometimes fail to give adequate alternative explanations, we must rationalize those results in a new way. This process is somewhat artificial, since the rationales I offer will not be those given by the courts that decided the cases. Tax-avoidance-motive explanations are so common that, for brevity’s sake, I shall discuss here only one recurring problem—“abuse” of the interest deduction—to illustrate how easily tax-avoidance cases can be explained on other grounds.

Clearly, no broad rule denies an interest deduction to a taxpayer who would not have incurred the interest in question but for the tax benefits of the deduction. A taxpayer who finds that the home-mortgage interest deduction makes going into debt to buy a house more attractive than renting will surely not lose his interest deduction if he confesses his motive. Indeed, many view the interest deduction as a tax subsidy to encourage home ownership, which assumes that people consider taxes in planning their lives. But the courts have balked at allowing the interest deduction where it is closely associated with the receipt of income that is either tax-free or taxed more favorably than the income sheltered by the interest deduction. Of the dozens of such cases, Goldstein v. Commissioner\(^5\)\(^2\) best illustrates this problem, since the transaction in that case was carefully planned and carried out.

In 1958, Tillie Goldstein won $140,218.75 in the Irish Sweepstakes. To ease the tax burden of having so much income in a single year, Mrs. Goldstein entered into a series of transactions to reduce her 1958 income and increase future years’ income, thus achieving a

\(52.\) 364 F.2d 734 (2d Cir. 1966), \textit{cert. denied}, 385 U.S. 1005 (1967).
"do-it-yourself" income averaging. The transactions, somewhat simplified, worked as follows: Mrs. Goldstein borrowed approximately $945,000 from two banks, prepaying $81,000 interest. With the proceeds of the loans, she purchased discounted Treasury notes, which paid a lower interest rate than the loans. The lenders retained the Treasury notes as security; indeed, Mrs. Goldstein never had possession of either the loan proceeds or the Treasury notes. Mrs. Goldstein deducted the prepaid interest in 1958 and reported interest income and a capital gain on the sale of the notes in 1959, 1960, and 1961. The transaction was planned to produce a net loss of $18,000 since the interest and capital gains received were about $12,000 less than the interest paid, and the taxpayer paid $6,500 for tax advice. Had the transactions been given their intended tax effect, Mrs. Goldstein would have come out ahead after taxes since the interest and capital gain income she received in 1959, 1960, and 1961 would have been taxed at a lower rate than the top $81,396 of her 1958 income without the interest deduction. In sum, Mrs. Goldstein hoped to forgo $81,396 of 1958 income, which would have been taxed at high rates because of "bunching," for a smaller amount of income taxed at lower rates because spread over several years.

The Commissioner's deficiency notice denied an interest deduction because "the transactions were devoid of profit motive" and were "entered in [sic] merely to reduce . . . federal income taxes." Holding for the Commissioner, the Tax Court said that the transaction produced "the 'facade' of a loan transaction" rather than a "genuine indebtedness." In this the court erred, since the loan transaction, looked at by itself, created at least as much indebtedness as loan transactions regularly given effect in real-estate tax shelters. The Tax Court also noted that the transaction could not have appreciably affected the taxpayer's beneficial interest in any way except to reduce her tax. This may have been an overstatement, though certainly the transaction was very unlikely to have produced a nontax profit, but even conceding the point, it does not by itself justify denying the interest deduction. In all interest transactions the taxpayer pays more than he gets back. The taxpayer who pays $100,000 (purchase price plus interest on the mortgage) to

54. 44 T.C. at 299.
55. 44 T.C. at 299.
56. The taxpayer argued on appeal that the Treasury notes might have increased in value and have been sold at a profit exceeding the interest the taxpayer paid on the money borrowed to buy the notes. 364 F.2d at 739.
acquire a $50,000 house has surely engaged in a transaction that produces a "loss" in the sense that he pays out more than he gets back, yet just as surely he can deduct the interest on the loan.

On appeal, the Second Circuit disagreed with the Tax Court's description of the loan arrangements as "shams" that created no "genuine indebtedness," but it affirmed on the ground that the taxpayer's sole purpose was to obtain an interest deduction, not to derive any economic gain. That, of course, restates the tax-avoidance-motive doctrine, avoiding direct conflict with the "right to decrease one's taxes" principle only by phrasing the doctrine indirectly. In essence, the Second Circuit's theory seems to have been that a transaction must have a "non-tax purpose" to be given its intended effect. That theory was recently endorsed by the Tax Court in a case involving the installment-sale provisions. But requiring that a transaction have a "non-tax purpose" to succeed simply insists circuitously that a transaction with only a tax purpose will fail. The Goldstein opinion, therefore, supports those who consider tax-avoidance purpose controlling.

Could a court that takes seriously the neutrality of tax-avoidance purpose have reached the Goldstein result? The answer is "yes," and the cases suggest possible grounds for such a result. The

57. 364 F.2d at 737-38.
58. 364 F.2d at 740-42. One wonders how Mrs. Goldstein would have fared if she had been able to convince the court that she had had a nontax reason for the transaction. What if she had testified persuasively that, like Justice Holmes, she liked to pay taxes and that she agreed to the scheme only to please her son, a creative C.P.A., who had dreamed up the transaction?
59. Wrenn v. Commissioner, 67 T.C. 576 (1976). This case involved a sale of appreciated stock by a husband to his wife under a contract meeting the formal requirements of I.R.C. § 453. On the same day, the wife sold the stock for cash on the open market. Finding no "bona fide purpose for entering into the...arrangement other than tax avoidance," and ruling that the taxpayer "must establish as a positive fact that the transfer in question was undertaken primarily for a bona fide purpose other than tax avoidance," the court refused to allow installment sale treatment. This cannot be an adequate explanation. One who makes an installment sale to a stranger who would have been willing to pay in full can surely elect installment sale treatment, despite the obvious absence of a nontax purpose for making an installment sale. There may well be good reason for distinguishing an "installment sale" like that in Wrenn from an installment sale to an outsider, but the distinction cannot turn on the existence of a "nontax purpose," which may be missing in either case. For one possible test, see Nye v. United States, 407 F. Supp. 1345 (M.D.N.C. 1975):
[A] taxpayer may, if he chooses, reap the tax advantages of the installment sales provision if he actually carries through an installment sale, even though this method was used at his insistence and was designed for the purposes of minimizing his tax. On the other hand, a taxpayer certainly may not receive the benefits of the installment sales provisions if, through his machinations, he achieves in reality the same result as if he had immediately collected the full sales price. As we understand the test, in order to receive the installment sale benefits the seller may not directly or indirectly have control over the proceeds or possess the economic benefit therefrom.
407 F. Supp. at 1349 (quoting Rushing v. Commissioner, 441 F.2d 593, 598 (5th Cir. 1971)) (citations omitted).
Goldstein transaction viewed as a whole differs drastically from all of the transactions one usually thinks of as involving interest payments. It is the essence of an interest transaction that one pay more than one receive, as did Mrs. Goldstein, but one usually pays a large sum over a long period in exchange for a small amount in the short run. Mrs. Goldstein did just the opposite: she paid a large sum in 1959 to receive a smaller one over the next three years. That fact alone justifies, if it does not require, treating the amounts she paid in 1959 as something other than interest. Her payments were simply not for the use of money. To be sure, by looking at the “borrowing” step of her transaction alone, one might say that she had received the use of money to buy the Treasury notes. But the purchase of the notes was intimately tied to the borrowing, and the notes were not available to her except as security for the loan, so no reason exists to examine the “borrowing” as if it were complete in itself. It was not a separate transaction, and the courts should not treat it as such.

This is not the only possible explanation of Goldstein, and it may not necessarily lead to the right result, for some theories of the function of the interest deduction would support Mrs. Goldstein’s claim. The example does show, however, that one who feels

60. See Estate of Franklin v. Commissioner, 544 F.2d 1045 (9th Cir. 1976), where Judge Sneed denied an interest deduction without relying on the lack of a nontax motive for entering the transaction in question. The taxpayer’s deceased was a limited partner in a partnership that bought a motel and other property and leased it back to the sellers. The transaction was arranged so that the seller-lessee’s lease payments equalled the partnership’s principal and interest payments. Thus, no cash would change hands for at least ten years, except for $75,000 “interest” prepaid by the partnership. The partnership’s purchase obligation was nonreourse. Since the purchase price was substantially more than the property’s fair market value, the partnership’s payments did not yield an equity in the property. Conceding that interest on nonrecourse debt is ordinarily deductible, the court nevertheless denied the interest deductions, saying, “Under these circumstances the purchaser had not secured ‘the use or forbearance of money.’” 544 F.2d at 1049 (quoting Norton v. Commissioner, 474 F.2d 608, 610 (9th Cir. 1973)). The Franklin situation is closely analogous to that of Goldstein: Mrs. Goldstein received no important present interest in the property securing the debt; the partnership in Franklin acquired no equity in the property purchased.

61. Lynch v. Commissioner, 273 F.2d 867 (2d Cir. 1959), is one of the many cases denying an interest deduction to a taxpayer involved in a “Livingstone transaction,” an arrangement substantially similar to that in Goldstein except that the intended tax advantage resulted from the payment of interest followed by the receipt of a smaller amount of capital gain, rather than from delay of the receipt. Most Livingstone transactions were not actually carried out as represented, and were easily dismissed by the courts as “shams.” Judge Friendly’s opinion in Lynch rejects the government’s invitation to deny the interest deduction on the ground that the transaction had no “purpose other than tax avoidance.” 273 F.2d at 871. Looking at the overall effect of the transaction, the court found that “no money was used or forborne.” 273 F.2d at 871-72.

62. See, e.g., R. Goode, THE INDIVIDUAL INCOME TAX 151-53 (rev. ed. 1976), pointing out the theoretical and practical problems of matching debt with particular assets. Suppose Mrs. Goldstein had been a wealthy taxpayer with a great deal of debt secured by some of her property, or not secured at all. Had she simply bought the Treasury notes, paying cash, none
Goldstein was right can reach that result without insisting upon striking down tax-motivated transactions.

What has been said thus far about case law applies equally to most statutory provisions that deny tax benefits to people who enter into transactions for tax reasons. Upon close examination, all such provisions prove to be punitive or to rest on considerations other than tax motive. The history of Congress's attempts to restrict the traffic in net-operating-loss carryovers provides a nice example. The predecessor of section 269 was passed in 1943 to prevent people from buying corporations with net operating losses and using those losses to offset income from a new venture. That section denied certain tax benefits if "the principal purpose" for the acquisition of control of a corporation, or for some acquisitions of corporate property, was "evasion or avoidance of Federal income tax."

Why was it undesirable for a profitable corporation to buy the stock of a loss corporation and use the latter's loss carryovers to reduce taxes? A plausible argument can be made that it is not undesirable at all. A market for loss carryovers could correct the "overtaxation" of corporations with unused losses by allowing, in effect, a refund to the corporation's owners by way of a tax reduction for the purchaser that passes on to the former shareholders of the loss corporation through the market. If a reason does exist to stop

of her interest deduction would have been disallowed, even though some of the interest she paid could have been viewed as interest paid to purchase the Treasury notes, since she could have used the money she paid for those notes to pay off some of her debts and thereby reduce her interest payments. One can accurately describe Mrs. Goldstein as a taxpayer who lost her case because she had little property, and thus had to secure the loan necessary to purchase the Treasury notes with the notes themselves.

63. E.g., I.R.C. § 877 (nonresident aliens who gave up United States citizenship with a principal purpose of avoiding taxes made potentially taxable).

64. See generally Cohen, Tax Avoidance Purpose as a Statutory Test in Tax Legislation, in PROCEEDINGS OF THE NINTH ANNUAL TULANE TAX INSTITUTE 229 (1960), which concludes that Congress's fondness for tax-avoidance purpose provisions stems from a lack of time to analyze problems fully and from an inability to agree on the proper objectives of the legislation in question. The result is the passage of "language which in essence condemns the sinful and upholds the virtuous." Id. at 254. The real issues are therefore left to the courts.

65. Tax Section Committee on Corporations, New York State Bar Assn., Report on Section 382 of the Internal Revenue Code as Amended by the Tax Reform Act of 1976, 31 THE TAX LAW. 283, 285-86 (1978) [hereinafter cited as Report on Section 382]; Asimow, Detriment and Benefit of Net Operating Losses: A Unifying Theory, 24 TAX L. REV. 1, 2 (1968); Brock, Past, Present and Future of Net Operating Loss Carryovers in Corporate Acquisitions, 43 TAXES 586, 596-97 (1965). See also S. REP. No. 94-938, 94th Cong., 2d Sess. 201-02 (1976), arguing that those who purchase stock or assets in order to acquire carryovers could get "large windfalls" by taking advantage of the "weak bargaining position of the existing owners of a loss business and acquire large carryovers for a few cents on the dollar." But the owners' bargaining position is weak only because of the difficulties of transferring carryovers. Carryovers would be valuable assets if they could readily be sold. The Senate Report itself notes this phenomenon. Id. at 203.
the traffic in loss carryovers, it is that the shareholders of the loss corporation suffer the detriment of the losses while the purchasers enjoy the benefit of the loss carryovers.\textsuperscript{66} Rather than responding directly to this problem, however, Congress first denied the benefit of the loss carryovers in the case of tax-motivated acquisitions.\textsuperscript{67} Some courts managed to apply section 269 so as to preserve loss carryovers, even in cases involving tax-motivated acquisitions, if the purchasers benefitting from the deductions were also the shareholders who suffered the earlier losses,\textsuperscript{68} but the results were inevitably haphazard since the statute was drafted without explicit reference to this continuity of ownership problem. More careful legislation gradually displaced section 269 with provisions focussing on the role of the old shareholders in the ownership of the corporation benefitting from the carryovers. Sections 381 and 382, as passed in 1954, expressly allowed loss carryovers to survive reorganizations within limits that depended on ownership of the surviving corporation by the shareholders of the loss corporation. Congress finally abandoned section 269 in 1976 (except for extreme cases) as a tool for dealing with loss carryovers. When the revised section 382 takes effect, trafficking in carryovers will be governed entirely by that section, which is concerned mostly with continuity of shareholder interest. According to the committee reports, section 269 is to be used against purchasers of carryovers only in the case of a "device or scheme to circumvent the purpose of the carryover restrictions."\textsuperscript{69} Thus, over thirty-three years the loss-carryover statutes evolved from a general provision ostensibly aimed at tax-motivated acquisitions into a set of rules designed to permit the survival of loss carryovers when, and only when, the shareholders who suffered the losses will enjoy the benefits of the carryovers. The current provisions might have been written in 1941;\textsuperscript{70} that they were not is a symptom of the

\textsuperscript{66} The Senate intended to reflect this position by eliminating the continuity of business rule in I.R.C. § 382(a). S. REP. No. 94-938, 94th Cong., 2d Sess. 202-03 (1976).

\textsuperscript{67} The traffic in loss carryovers was the principal reason for the passage of the predecessor of § 269. Rudick, \textit{Acquisitions To Avoid Income or Excess Profits Tax: Section 129 of the Internal Revenue Code}, 58 HARV. L. REV. 196, 200-06 (1944).

\textsuperscript{68} E.g., Zanesville Investors Co. v. Commissioner, 335 F.2d 507 (6th Cir. 1964). The carryover cases under § 269 and the enactment of I.R.C. §§ 381 & 382 are discussed in detail in Asimow, \textit{supra} note 65.

\textsuperscript{69} S. REP. No. 94-938, 94th Cong., 2d Sess. 206 (1976). Whether § 269 is as dead as the Committee seems to have intended is open to question. See \textit{Report on Section 382, supra} note 65, at 288, noting that the language quoted in the text gives very little guidance as to whether § 269 can still apply in specific cases.

\textsuperscript{70} I do not mean to defend § 382, which even for a tax provision is arbitrary, mechanical, and excessively complex. For a discussion of its problems, see \textit{Report on Section 382, supra} note 65.
tendency to avoid grappling with complex problems by invoking ill-
considered notions of tax avoidance.

E. Bad Law

As previously suggested, many of the cases striking down tax-
motivated transactions because of that motive have reached sensible
results, but the reliance on the presence or absence of such a motive
has led inevitably to some plainly wrong decisions. If tax motive is
not by itself a legitimate reason for denying tax benefits, some tax-
payers will be denied benefits they should receive. The gift and
leaseback cases illustrate this point.71 But more seriously, the wide-
spread acceptance of the notion that tax-motivated transactions
should fail may encourage mechanical and literal application of the
statutory language, even though the results reached border on ab-
surdity, when the taxpayer does not have a tax motive. The ten-
dency to accept tax motivation as a justification for creative statutory
interpretation may well have created a climate of judicial opinion in
which a finding of tax-reduction purpose has become the only justifi-
cation for giving the statute a non-literal reading.

The Ninth Circuit's decision in Breech v. United States72 dramatically
exemplifies a transaction taxed more lightly than it should
have been because the transaction in question was found to have
been motivated by nontax considerations. The taxpayers, Drum-
mond, Breech and Haensli, were the shareholders of a corporation
(Valley-1) which sold its assets to a new corporation (Valley-2).
Drummond owned twenty per cent of Valley-2. San Jose, a corpo-
ration controlled by Breech and Haensli, owned the other eighty per
cent. Valley-1 liquidated, distributing the sale proceeds to the tax-
payers. The government contended that the transaction was a “D”
reorganization in which the cash distributed to Valley-1’s sharehold-
ers was boot, taxable as dividends to the extent of Valley-1’s earnings
and profits. This argument would surely have prevailed had the
Valley-1 shareholders owned the Valley-2 stock directly.73 The gov-
ernment argued that San Jose’s ownership of Valley-2’s stock consti-
tuted ownership by “any combination” of Valley-1’s shareholders,
 thus bringing the transaction within section 368(a)(1)(D); and that
the transaction was not in any event a liquidation, since Valley-1’s

71. See text at note 26 supra.
72. 439 F.2d 409 (9th Cir. 1971).
73. See, e.g., Reef Corp. v. Commissioner, 368 F.2d 125 (5th Cir. 1966); James Armour,
assets remained in corporate solution. But the court refused to read the statutes in that way and accepted a finding of a “valid business purpose” for the sale and for the creation of Valley- though it hinted that the government would have won but for the “business purpose” behind the transaction. This holding ignores the distinction between liquidations and reorganizations: in a liquidation the corporate assets are transferred to the shareholders or sold to strangers and the sale proceeds are transferred to the shareholders, while in a reorganization the operating assets remain in corporate solution. In Breech, a decision supported only by the “business purpose” finding, literalism triumphs over common sense. Tax motivation should be irrelevant to reorganization classification. If Breech’s transaction would have been taxed as a reorganization when he had a tax motive, it should have been taxed as one when he did not.

The Supreme Court’s recent decision in United States v. Consumer Life Insurance Co. likewise illustrates what seems to be an increasing tendency of the courts to refuse to inquire deeply into problems of statutory interpretation except when faced with a plainly tax-motivated event. The issue in Consumer Life was whether the taxpayer was a “life insurance company” as defined by section 801(a). The resolution depended upon whether the taxpayer’s “life insurance reserves” were more than half of its total reserves. The taxpayer, which had made certain reinsurance arrangements with other insurance companies with regard to its non-life insurance policies, argued successfully that the reserves for non-life policies were attributable to the reinsurers, not the taxpayer, thus making the taxpayer a life-insurance company even though the risk of the non-life-insurance business remained upon the taxpayer. In his dissent, Justice White pointed out that the Court’s decision “makes it possible for insurance companies doing almost no life insurance business to qualify for major tax advantages Congress meant to give only to companies doing mostly life insurance business.”

75. The district court found a “genuine business purpose in the dissolution of the old corporation and in the creation of the new corporation.” 68-2 U.S. Tax Cas. ¶ 9584, at 88,028 (C.D. Cal. 1968), affd., 439 F.2d 409 (9th Cir. 1971). The Ninth Circuit’s reference to a business purpose for “the challenged transactions,” may suggest that a business purpose for each detail of the transaction is unnecessary. 439 F.2d at 411.
77. 430 U.S. 725 (1977).
78. 430 U.S. at 753 (White, J., dissenting opinion).
This argument should have been persuasive, since neither the language of the statute nor the legislative history compelled the result reached. The majority's only answer was that state regulation would prevent "overreaching" and that the reinsurance agreements served a business purpose.\textsuperscript{80} \textit{Consumer Life} is an all-too-typical example of the willingness of many courts to ignore reality except when presented with a plainly tax-inspired device.

II. "PREVENTION OF TAX AVOIDANCE" AS A RATIONALE FOR RULES OF TAXATION

A. The Problem

Many rules of the tax law are commonly justified as necessary to prevent tax avoidance. This need not mean merely that tax-motivated transactions should not be given their intended effect. Randolph Paul, for example, seems to concede that tax-avoidance purpose has little place in determining the tax liability of unambiguous acts,\textsuperscript{81} but he has also said that "determined tax avoidance" must be prevented.\textsuperscript{82} The assignment of income doctrine and its statutory variation, section 482,\textsuperscript{83} are usually explained, when justified at all,\textsuperscript{84} as needed to prevent tax avoidance,\textsuperscript{85} though the case that created the doctrine, \textit{Lucas v. Earl},\textsuperscript{86} involved an assignment that was certainly not tax-motivated. The idea that Congress and the courts should fashion rules to prevent tax avoidance sounds appealing, for

\textsuperscript{79} 430 U.S. at 749.
\textsuperscript{80} 430 U.S. at 736-39.
\textsuperscript{82} Paul, \textit{Motive and Intent in Federal Tax Law}, in \textit{id.} 255, 302.
\textsuperscript{83} See text at note 89, infra.
\textsuperscript{84} McIntyre & Oldman, \textit{Taxation of the Family in a Comprehensive and Simplified Income Tax}, 90 \textit{HARV. L. REV.} 1573, 1582 (1977), find the doctrine to be "without support in any normative model of the income tax." The only "normative model" discussed is the Haig-Simons definition, which is not usually thought of as a guide to problems of choosing the person taxable on income.
\textsuperscript{85} See, e.g., almost any book, article, court decision, or revenue ruling dealing with the assignment of income problem. For a recent example, see United States \textit{v. Basye}, 410 U.S. 441 (1973). The Court said that "liability may not be avoided through an anticipatory assignment of...income" and that an income earner "cannot avoid taxation by entering into a contractual arrangement whereby that income is diverted to some other person or entity," 410 U.S. at 447, 449. The Court added that assignments of income "have frequently been held ineffective as means of avoiding tax liability," and read \textit{Lucas v. Earl}, 281 U.S. 111 (1930), as holding "that he who earns income may not avoid taxation through anticipatory arrangements no matter how clever or subtle." 410 U.S. at 450.
\textsuperscript{86} 281 U.S. 111 (1930). The assignment in \textit{Earl} was made by contract in 1901. A taxpayer with the ability to predict the sixteenth amendment and the progressive income tax would surely have been able to predict the \textit{Lucas v. Earl} holding as well.
a rule permitting tax avoidance impresses those concerned with a reasonably fair distribution of tax burdens as a bad one. But statements about the necessity of preventing tax avoidance prove upon examination to be question-begging.

What can someone mean by saying that a rule is necessary to prevent tax avoidance? If he means merely that the rule is desirable because it would defeat tax-motivated transactions, he is wrong for the reasons given above. Just as clearly, however, he cannot mean merely that the rule would tax people more heavily than they would be taxed without it, for no general principle favors rules that impose heavier tax burdens over rules that impose lighter burdens. "Tax avoidance" in this context cannot mean simply "tax reduction." If it means more than that, and if it does not describe tax-motivated conduct, it must mean the reduction of taxes in circumstances where taxes should not be reduced. This in fact seems to be what people mean by asserting that tax avoidance must be prevented. But once clarified, the "doctrine" plainly fails as an explanation. Claiming that people should not be able to reduce their taxes by doing certain things merely raises the question why people who do those things should not have their taxes reduced. When one argues, for example, that the owner of a coupon bond should not be allowed to avoid taxes by giving some of the coupons to a son before maturity,87 one says simply that the bond owner should be taxed as if he had kept the coupons. The conclusion may be sound, as it surely is in this case, but statements like these are inherently conclusory; they do not explain why the transactions in question should not result in a reduction of tax.

In many cases a particular rule is so obviously necessary that explaining it as "needed to prevent tax avoidance" does no particular harm. Suppose someone suggested that all noncash benefits received in exchange for the performance of services be exempt from taxation. This rule would make unnecessary the difficulties of valuing noncash compensation and would prevent the occasional hardship of paying taxes at the time of a transaction that gives the taxpayer nothing with which to pay that tax. But the objection would surely be made that the proposal would encourage employees to arrange with their employers for non-cash compensation, thus "avoiding" the tax on their earnings. That objection is conclusory; the real reason for taxing noncash compensation is that there is no real difference between an employee who receives cash which he

uses to buy goods and an employee who receives goods directly.\textsuperscript{88} The "tax-avoidance" explanation in this case simply states a conclusion so obviously sound that few would press for an explanation.

B. An Example: The Assignment of Income Doctrine

Conclusory statements of the necessity of preventing tax avoidance cease to be adequate where the answers to problems are not obvious. The reason for a rule must be understood if we hope to apply the rule sensibly in close cases. Since labelling the assignment of income doctrine "needed to prevent tax avoidance" merely approves the doctrine indirectly, the label cannot help and may even mislead a court deciding whether to apply the doctrine in an unclear case. One recurring problem in this area is whether assignment of income principles (or section 482, which for most purposes is the same thing)\textsuperscript{89} require taxing someone whose work has earned income, but who could not have received that income for some reason. The classic assignment of income cases—\textit{Lucas v. Earl},\textsuperscript{90} \textit{Helvering v. Horst},\textsuperscript{91} and \textit{Commissioner v. Culbertson},\textsuperscript{92} for example—involves taxpayers who could have received the income themselves if they had not given it away. Was this factor controlling? One is likely to answer "yes" if one thinks of the assignment of income doctrine as a

\textsuperscript{88} This rationale explains only the most obvious fringe benefit cases, such as \textit{Old Colony Trust Co. v. Commissioner}, 279 U.S. 716 (1929), which held an employee taxable on amounts paid by his employer directly to the government in satisfaction of the employee's tax liability. The questions become more troublesome if the fringe benefit consists of an item the employee would not or might not have purchased, such as travel passes for airline employees or free tuition for college employees' children.

\textsuperscript{89} \textit{See}, e.g., \textit{Phillipp Bros. Chems., Inc. v. Commissioner}, 435 F.2d 53, 57 (2d Cir. 1970) (§ 482 "rests on" the policy of taxing income to its earner); \textit{Olla State Bank v. United States}, 77-1 U.S. Tax Cas. ¶ 9455, at 87,149 (W.D. La. 1977) ("Section 482 only provides a method for making the determination allowed by § 61 and is not a force of less power than § 61"). \textit{But cf. Ronan State Bank v. Commissioner}, 62 T.C. 27, 35 n.3 (1974) (distinguishing Commissioner v. First Security Bank, 405 U.S. 394 (1972), on the grounds that the taxpayer in 

\textit{Ronan} had actually received the illegal income in question and that the Commissioner was proceeding under § 61 rather than § 482). In \textit{First Security} and United States v. Basye, 410 U.S. 441 (1973), the Court discussed both § 61 cases and § 482 cases as if they were equally authoritative guides to the questions before it. Section 482 may be broader than § 61, in the sense that § 482 can be used in some cases to allocate income to a taxpayer who would not be regarded as the person taxable on that income under § 61. Indeed, if this were not true, it would be hard to see what function § 482 serves or why there is so much litigation over its applicability. Nonetheless, I am hard-pressed to think of any good examples, except, perhaps, the creation-of-income cases recently summarized in \textit{Latham Park Manor, Inc. v. Commissioner}, 69 T.C. 199 (1977). In any event, differences in scope between § 482 and § 61 have no bearing on the issue of "illegal unreceived income" in \textit{First Security}. \textit{Contra, Comment, Commissioner v. First Security Bank: Allocability Under Section 482 of Legally Nonreceivable Income}, 122 U. Pa. L. Rev. 184, 195-96 (1973).

\textsuperscript{90} 281 U.S. 111 (1930).

\textsuperscript{91} 311 U.S. 112 (1940).

\textsuperscript{92} 337 U.S. 733 (1949).
device to prevent tax avoidance, for “avoidance” usually connotes voluntary action. Someone who quits his job, for example, can be thought of as “avoiding” taxes in a very weak and certainly non-pejorative sense, while someone who was fired would surely never be described in that way. And the courts, probably because of their infatuation with the notion that the assignment of income doctrine has something to do with tax avoidance, have in fact distinguished involuntary assignments from others. In *Commissioner v. First Security Bank,* the taxpayers were banks which sold insurance policies to borrowers. The banks were prohibited by law from selling insurance, and the premiums on the insurance in question were received by an insurance company subsidiary of the holding company that owned the banks. The Supreme Court, finding that the banks “could never have received a share of [the] premiums,” held that none of the premium income could be allocated to the banks under section 482. In *United States v. Basye,* however, where income earned by a medical partnership was paid by the recipient of the services directly to a retirement trust for the benefit of the partnership’s doctors, the Court held *Lucas v. Earl* controlling and taxed the income to the partners. The Court thought *First Security* distinguishable since it had involved “a deflection of income imposed by law, not an assignment arrived at by the consensual agreement of two parties acting at arm’s length as . . . in the present case.” This distinction is inadequate, for the “deflection” involved in any assignment of income case is “imposed by law,” typically the law of contracts or of gifts. The distinction is, however, suggested by phrases like “preventing tax avoidance.”

The validity of the distinction between *Basye* and *First Security* ultimately depends on whether the policies underlying the assignment of income doctrine dictate it. Unfortunately, the courts have been content to defend the doctrine by conclusory references to tax

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94. Justice Marshall, dissenting in *First Security,* 405 U.S. at 412, believed that the selling activities of the banks violated the statute in question, 12 U.S.C. § 92 (which is no longer part of the United States Code, but which is incorporated in regulations issued by the Comptroller of the Currency, 405 U.S. at 401 n.12), but the majority read the statute as barring only the receipt of premiums from insurance sales. 405 U.S. at 402.
95. 405 U.S. at 401.
97. 410 U.S. at 453 n.13.
98. Though entirely imaginary, this distinction may be firmly embedded in history. See *Poe v. Seaborn,* 282 U.S. 101 (1930) (holding half of the salary earned by a husband in a community property state taxable to his wife because she “owns” that half). *Seaborn* cannot be corrected at this late date, but it surely should not be extended.
avoidance and by invoking the notorious “fruit and tree” metaphor, and have not identified the doctrine’s policies. Yet the real reasons for the doctrine—convenience and fairness—are so obvious that they can be described with some confidence, despite the dearth of judicial statements.

The choice between applying or not applying the assignment of income doctrine is usually a choice between taxing the person who earns income or controls income-producing property and taxing the person who “benefits” from the income in question. Some common definitions of income suggest the benefit approach,99 but while that approach has some intuitive appeal, “benefit” does not satisfactorily identify the person to report income for tax purposes. Almost any transfer of money can easily be viewed as benefitting any number of people: the recipient of the money, his family, those who expect to become his heirs, and his creditors, to name but a few. If we took the benefit notion seriously we would have to engage in impossibly complex tracing to identify taxpayers. Indeed, since the concept of income is almost meaningless without reference to the person whose income is being determined,100 the very idea of tracing income from one person to another may be useless. One can trace money, of course, but income is not money.101 In most cases, however, it is relatively simple to identify the person whose activities have enhanced wealth or who owns income-producing property. This extremely practical consideration alone justifies taxing income to its earners. If not to them, to whom?

Even if it were possible to identify those who first receive the money transferred in income-producing transactions as those who benefit from income, an assignment of income doctrine would be a

99. See McIntyre & Oldman, supra note 84, at 1575, which relies on the Haig-Simons definition of income to support the argument that “income should be attributed to the person who uses or benefits from the income.” As McIntyre and Oldman realize, a tax system based on this theory would have no place for an assignment of income doctrine.

100. One can easily imagine money without an owner, at least for a time, as in the instance of money buried in a jar by someone who has died. However, except perhaps for income from property, one cannot even think of income without thinking as well of a person whose income is described. The common confusion of income with money illustrates nicely the “category mistake.” See generally G. Ryle, THE CONCEPT OF MIND (1949).

101. H. SIMONS, PERSONAL INCOME TAXATION 51 (1938) (income is “merely an arithmetic answer and exists only as the end result of appropriate calculations”). I do not mean to suggest that everyday references to the “receipt of income” are incorrect. In most cases a statement like “X has received income” so clearly means “X has received money in an income-producing transaction” that the shorter formation misleads no one. An improvement in style may more than outweigh a slight cost in lack of verbal precision. But people who commonly refer to “income” when they mean “money” (myself included) should take care not to let a shorthand expression foreclose clear thinking about problems whose resolution requires an appreciation of the differences between income and money.
necessary adjunct to any tax system designed to tax equally those who are similarly situated. Since one who earns money and then gives it away or spends it in a nondeductible way is taxed, fairness requires that those who give money away before it is earned also be taxed. The difference between a taxpayer who gets money and then gives it away and one who gives the money away shortly before receiving it is surely too trivial to justify important differences in taxation. Like most doctrines justified by the idea of equal treatment of equals, this one must yield to practical considerations, and the contours of the assignment of income doctrine have largely been shaped by the practical difficulties of identifying income earners who have given up significant rights. The difference between cases like Helvering v. Horst, which tax the transferor of a carved-out income interest on the income when received, and rules that tax the donee of property on the income it earns is more convenient than principled. If A gives stock to B, we might say that the situation is much the same as that in which A kept the stock and gave the dividends to B, and so tax the dividend income to the donor. But having started down this road, where should we stop? At some point B clearly becomes the earner of the income. For example, when B has sold the stock and invested the proceeds in something else, B's business acumen, not A's, has earned the income. For this reason some rather arbitrary lines must be drawn, particularly in cases involving income from property, and so the assignment of income doctrine has been limited to such cases as assignments of earned income, of carved-out income interests in property retained, and of income

102. This explanation of the assignment of income doctrine appears most clearly in the I.R.C. § 482 regulations, which compare related taxpayers dealing with commonly controlled entities and taxpayers engaging in similar transactions with unrelated persons.

103. 311 U.S. 112 (1940).

104. Even if B has not sold the stock we could properly regard the income as his, since his decision not to sell it and invest in something else produced the income.

The facts of Greer v. United States, 408 F.2d 611 (6th Cir. 1969), suggest a case in which a mechanical application of that aspect of the assignment of income doctrine concerning carved-out income interests would lead to an arguably wrong result. The taxpayer in Greer assigned a fractional "racing interest" in a horse to his children, retaining the rest of his share of the racing interest and his entire share of the breeding interest (the right to breed the horse after its racing life ended). Greer is complicated by the taxpayer's retention of a majority of his original share of the racing interest, but it seems to me that if the owner of a horse gives away all of his racing interest, he should not be taxed on race winnings even if he retains the breeding interest. Those winnings depend largely upon the horse's training and riding, and on the choice of races, all of which are controlled by the owner of the racing interest. A racing interest like that in Greer can be regarded as an interest "carved out" of complete ownership of a horse, but it is not passive income like that in Horst. To carry this example to an extreme, would anyone seriously argue that a bribe accepted by the donee of a carved-out racing interest to withdraw his horse from an important race would be income to the donor?
“accrued” in a loose and nontechnical sense.105

If one clearly understands the reasons for the assignment of income doctrine, First Security and Basye present no serious problems. As the Court recognized, Basye is a clear case for applying the doctrine106 and is undoubtedly right; First Security is wrong. None of the reasons for taxing income to the person who earns it and controls its distribution has anything to do with whether an assignment was voluntary. Indeed, it may even be misleading to say that the assignment of income cases invoke a “doctrine,” for that implies that they do something unusual. The doctrine provides no remarkable technique for taxing one person’s income to another; it is part of the process of defining income. That process necessarily involves defining the person whose income is under consideration. The assignment of income cases do not in fact involve assignments of income. They involve assignments of money, which are not at all the same thing, and they hold that an assignment of money, even before it is received, does not assign the income connected with the receipt of that money. So viewed, the assignment of income cases merely apply the familiar though often ignored principle that income is not money, or even anything like money.107 The First Security opinion confuses “income” and “money.”108 The law of banking can surely


106. Basye is clear at least if we view the problem as the Court and, apparently, the litigants did, as a question of identifying the person to whom the income was to be taxed (i.e., the partnership or the trust) rather than as a pure timing problem. A taxpayer who agrees in advance to the postponement of income is not taxed on the income when he could have received it, e.g., Rev. Rul. 60-31, 1960-1 C.B. 174, a rule which initially seems at odds with the assignment of income doctrine. See Eisenstein, A Case of Deferred Compensation, 4 Tax L. Rev. 391 (1949) (arguing, in effect, that it is anomalous to refuse to give effect to an assignment of income from one taxpayer to another while permitting an assignment from the taxpayer to himself at a future date). In any event, the principal reason given in Rev. Rul. 60-51 for allowing the taxpayer to delay income recognition by contract—the administrative problem of deciding whether the payor would have paid the money earlier—does not arise in a case like Basye, where the payor did pay someone. Cf. Proposed Treas. Reg. § 1.61-16 (1978) (taxpayer with “individual option” to defer part of “basic or regular compensation” taxed when deferred payment could have been received).

107. See note 101 supra.

108. In Paul A. Teschner, 38 T.C. 1003 (1962), a case cited with apparent approval by the Supreme Court in First Security, a majority of the Tax Court held that the winner of a contest who won the right to designate any person under the age of seventeen to receive a college scholarship could not be taxed on his winnings. The Tax Court, noting that the taxpayer could not have designated himself as the recipient, seemed to think that a decision taxing Teschner would have required taxing employees on income produced by their efforts but kept by their employers. That is not persuasive, since an accurate analogy from Teschner would require that at some time the taxpayer have the power to choose whether to do the work in question and to designate the person to receive the money he earns, choices the employee does not have. The exercise of a power to earn money to be paid to a relative (Teschner) or a sister corporation (First Security) differs greatly from the case of an employee who works hard for a small salary (except where the employer is, for example, the employee’s own corporation, in
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require the assignment of the money. But whether something is income is a tax question, to be answered by the tax laws on the basis of tax criteria. And nothing in the tax law is clearer than the rule that legality under nontax law has nothing to do with taxability.109

III. Conclusion

My criticism of undue reliance on fuzzy notions of preventing tax avoidance and indefensible distinctions between tax-motivated and other behavior is not an argument that the tax laws should ignore the well-known desire of taxpayers to reduce their taxes. Few taxes are meant to be optional, and many tax rules have proved unsatisfactory in practice because they were made with an incomplete appreciation of the measures people would take in response.110 I have argued that the question whether particular conduct was tax-motivated should be irrelevant to the decision whether that conduct should be taxed in a certain way. This differs greatly from suggesting that the likelihood of tax-motivated responses to announced principles of taxation should be ignored when those principles are formulated. An authoritative rule is likely to be too narrow if its author fails to foresee taxpayer response.111

Justice Holmes’ opinion in Lucas v. Earl nicely illustrates the need to anticipate taxpayer reaction to the law. Earl assigned half his income to his wife. It might have been argued that his assignment should have failed because the wife was not a party to the contract of employment between Earl and his employer. The right to which case IRC § 482 can be used to allocate an “arm’s length” salary to the employee). Whether Teschner survives Basye is doubtful.


The taxpayer in Barbara M. Bailey, 52 T.C. 115, aff’d per curiam, 420 F.2d 777 (5th Cir. 1969), was a bank employee who had embezzled funds by crediting her brother’s account. Although the taxpayer never received, or intended to receive, any of the money herself, the court had no difficulty in holding that she, rather than her brother, was taxable on the income, since she had “exercised complete dominion and control over the embezzled funds” by diverting them to her brother, 52 T.C. at 119.

110. For example, the accumulated earnings tax is in effect a tax on failure to retain competent counsel. On the Estate Tax, see generally Cooper, A Voluntary Tax? New Perspectives on Sophisticated Estate Tax Avoidance, 77 COLUM. L. REV. 161 (1977). A dramatic, if trivial, failure was I.R.C. § 120, which excluded from gross income the amount of “statutory subsistence allowances” paid police officials. This section was repealed when police forces began doing the obvious.

111. The phrase “preventing tax avoidance” cannot tell us whether we should have an assignment of income doctrine, but once we decide we should, we must consider tax avoidance in shaping the doctrine so that it will apply to at least most of those who should, given the reasons for having the doctrine, be subject to it. “Tax avoidance” considerations alert us to future fact situations that may raise problems, but such considerations can never tell us how those problems should be solved.
his salary could have been said, therefore, to have vested in him at
least briefly before accruing to his wife. The Court declined to
decide the case upon such "attenuated subtleties" and announced
the broader rule that salaries are taxed to the person who earns them.
Had the Court decided the case on the technical ground that Earl
alone held title to the earnings before passing it to his wife, well-
advised taxpayers could easily have assigned their incomes by mak-
ing the assignees parties to the contracts under which the incomes
were earned. The reason these more careful taxpayers should not
have succeeded where Earl failed is not that they were tax-moti-
vated, but simply that the distinction between an assignment effected
by altering an employment contract and an assignment made by
adopting an additional contract is wholly formal and cannot reason-
ably support a difference in tax treatment. Holmes knew that tax-
payers would enter into "anticipatory arrangements and contracts . . . skillfully
devised" if the case were decided on technicalities. That may well have been at least one reason the Earl opinion an-
nounced the sweeping rule now regarded as the cornerstone of our
tax system.

Many regard the language of statutes as more authoritative than
the language of judicial opinions, since the latter is routinely cor-
rected retroactively when necessary. The failure to foresee tax-moti-
vated responses is more troubling, therefore, in legislation than in
judge-made law. The abstruse complexities of corporate reorgani-
ization law, for example, are largely attributable to Congress's contin-
uing failure to grasp the elementary fact that many people find it in
their interest to take money out of ongoing corporate ventures by
arranging transactions so that they fall outside the definitions of re-
organizations. By defining reorganizations in an apparently
mechanical and highly detailed way, Congress has provided those
who do not want reorganization treatment with an incentive to plan
corporate reshapings so as to achieve nontax reorganization results
without the attendant tax consequences. Much judicial ingenuity

112. The court of appeals had decided for the taxpayer, distinguishing Blair v. Roth, 22
F.2d 932 (9th Cir. 1927), cert. denied, 277 U.S. 588 (1928), on the ground that the Roth
contract had provided for an assignment of funds after they were earned, while the Earl
contract effected an instantaneous transfer. 30 F.2d 898, 899 (9th Cir. 1929), rev'd., 281 U.S. 111 (1930).
113. 281 U.S. at 115.
114. The taxpayer in Basye argued essentially for the distinction Justice Holmes ridiculed
as an "attenuated subtlety" in Lucas v. Earl, 281 U.S. 111, 114 (1930). But for the First Security
opinion, the Basye decision would so clearly have been a routine application of settled law that
it would not have merited discussion.
115. This is the familiar "liquidation-reincorporation" problem, one successful variation of
which is the transaction described in the Breech case. See text at notes 72-76 supra.
Tax Avoidance has been needed to keep the reorganization rules from becoming entirely elective. To be sure, one can hardly expect Congress to anticipate and deal expressly with all possible taxpayer responses to its reorganization rules. But had the threat been foreseen even in a rough way, Congress might have drafted those statutes in broad and general terms, leaving the courts to fill in the details in the light of experience.  

The most important practical advantage in thinking about tax avoidance may be that someone who does so will understand the hopelessness of trying to deal in advance with complicated problems by laying down mechanical rules. The world in which a law will operate may not be the same as the world the lawmaker imagined, for people change their behavior in response to the law.

Any sensible body of law must be in large part retroactive and therefore made by courts. The retroactive nature of judicial law-making, often viewed as a fundamentally unjust necessity tolerated to reward litigants for their efforts to clarify the law, is really a strength, not a weakness, of the judicial process. The judge knows better than the legislator the facts to which his law will apply, and the most successful tax legislation has been the most general.

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117. Cf. L. FULLER, ANATOMY OF THE LAW 100 (1968): Why, then, is the covert lawmaking implicit in the act of interpretation regarded as being exempt from the taboo against retrospective laws? To answer this question we have to consider, as with many problems in the design and operation of social institutions, whether there exists any acceptable alternative. . . . Plainly, if the result of . . . litigation were an interpretation that was operative prospectively and for future controversies only, then the whole purpose of providing a means for securing an authoritative resolution of pending disputes would be thwarted. Except for the cases (and there are very few of them in tax litigation) in which a litigant has reasonably relied upon some settled rule, or in which the law is intended to direct people's behavior, it seems to me to be odd to begin a discussion of lawmaking by assuming that retroactive lawmaking is unfair. No principle of justice is more basic than "treating like cases alike"; making a new rule prospective does precisely the opposite. It treats like cases differently because of the happenstance that one arose before the other. The intuitively appealing (to me) way of approaching retroactivity is to ask not why judges are ordinarily allowed to make law retroactively, but why legislatures are ordinarily not expected to make their laws retroactive. For an answer to this, see Justice Harlan's opinion in James v. United States, 366 U.S. 213, 247 n.3 (1961) (concurring in part and dissenting in part):

Aside from problems of warning and specific intent, the policy of the prohibition against ex post facto legislation would seem to rest on the apprehension that the legislature, in imposing penalties on past conduct, even though the conduct could properly have been made criminal and even though the defendant who engaged in that conduct in the past believed he was doing wrong (as for instance when the penalty is increased retroactively on an existing crime), may be acting with a purpose not to prevent dangerous conduct generally but to impose by legislation a penalty against specific persons or classes of persons. That this policy is inapplicable to decisions of the courts seems obvious: their opportunity for discrimination is more limited than the legislature's in that they can only act in construing existing law in actual litigation.