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Formalism in the Tax Law

David A. Weisbach†

The tax law is the paradigmatic system of rules. Over thirteen large black volumes filled with tax rules sit on my shelf. Yet over the last several years, the purely rule-oriented approach to the tax law has begun to be perceived as a failure. The reason is that taxpayers have been able to manipulate the rules endlessly to produce results clearly not intended by the drafters. Manipulation of this sort is inefficient, loses revenue, and demoralizes others.

To respond, lawmakers and regulators have shifted the tax system toward standards, primarily by adopting what are known as “anti-abuse rules.” A typical anti-abuse rule allows the government (and only the government) to override the literal words of a statute or regulation. Instead, the government may require a “reasonable” tax result if the taxpayer enters into or structures a transaction with a principal purpose of reducing tax liabilities in a manner contrary to the purposes of the statute or regulation, even if the transaction otherwise literally complies with the rules.¹

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¹ See Treas Reg § 1.701-2 (the partnership anti-abuse rule), Treas Reg § 1.1275-2(g) (the original issue discount (“OID”) anti-abuse rule), and Treas Reg § 1.1502-13(h) (the intercompany transaction anti-abuse rule) for examples of typical anti-abuse rules. The most important operative provision of the partnership anti-abuse rule is “if a partnership is formed or availed of in connection with a transaction a principal purpose of which is to reduce substantially the present value of the partner’s aggregate federal tax liability in a manner that is inconsistent with the intent of subchapter K, the Commissioner can recast the transaction.” Treas Reg § 1.701-2. Similarly, the OID anti-abuse rule provides in relevant part, “[I]f a principal purpose in structuring a debt instrument or engaging in a transaction is to achieve a result that is unreasonable in light of the purposes of section 163(e), sections 1271 through 1275, or any related section of the Code, the Commissioner can apply or depart from the regulations under the applicable sections as necessary or appropriate to achieve a reasonable result.” Treas Reg § 1.1275-2(g)(1). Other anti-abuse rules can be found throughout the Internal Revenue Code and Treasury Regulations. For a small sample, see IRC § 1031(f)(4) (1994) (stating that section 1031 (granting nonrecognition on exchanges of like kind property) “shall not apply to any exchange which is part of a transaction (or series of transactions) structured to avoid the purposes of [subsection 1031(f)]”); IRC § 269 (1994) (prohibiting corporate acquisitions with a purpose of avoiding tax); IRC § 7701(f) (1994) (permitting the IRS to issue regulations to prevent avoidance of those provisions of the Code dealing with the linking of borrowing to investment or di-

A common reaction to anti-abuse rules is horror. Anti-abuse rules seem to eliminate certainty and reliability in the tax law. They replace reliance on the rules with a one-way law favoring the government, administered at the discretion of government agents, and dependent upon the taxpayer's purposes or thoughts rather than his actions. After all, how can people fill out their tax returns unless the law is clear?

The tax law has, however, long included principles that have effects similar to anti-abuse rules, such as substance over form, the step transaction doctrine, and the sham transaction doctrine.² The only real difference between these common law tax doctrines and anti-abuse rules (other than the detailed specifics of their applicability) is that, instead of being developed by the courts, anti-abuse rules are incorporated directly into the regulation or statute, thereby eliminating the statutory (or regulatory) interpretation question. With anti-abuse rules, we must face directly whether the approach is desirable.³

This Article addresses the question of whether (or when) anti-abuse rules are desirable. The answer was suggested thirty years ago by Stanley Surrey: "It is clear that [various anti-avoidance provisions in the law at that time] save the tax system from the far greater proliferation of detail that would be necessary if the tax avoider could succeed merely by bringing his scheme within the literal language of substantive provisions written to govern the everyday world."⁴ That is, the most important feature of anti-abuse rules is their substitution of standards for rules. We want the advantage of rules (Surrey's substantive provisions), but in the tax law, rules alone would have to be unduly complex to prevent avoidance. Anti-abuse rules allow the tax sys-

minishing risks through the use of related persons); IRC § 7701(l) (permitting the IRS to issue "regulations recharacterizing any multiple-party financing transaction as a transaction directly among any 2 or more of such parties where the [IRS] determines that such recharacterization is appropriate to prevent avoidance of any tax"); Treas Reg § 1.246-5(c) (anti-abuse provision regarding reduction of "holding period of stock for purposes of the dividends received deduction"); Treas Reg § 1.446-3(i) (anti-abuse provision regarding use of notional principal contracts); Treas Reg § 1.1502-32(e) ("anti-avoidance" rule for "adjusting the basis of the stock of a subsidiary [] owned by another member").

² For a description of these rules, see Alan Gunn, *Tax Avoidance*, 76 Mich L Rev 733 (1978) (criticizing anti-abuse rules and arguing against inquiry into a taxpayer's purpose).

³ Much of the literature on court generated anti-abuse principles focuses on questions of statutory interpretation. See, for example, Joseph Isenbergh, *Musing on Form and Substance in Taxation*, 49 U Chi L Rev 859 (1982) (book review).

⁴ Stanley S. Surrey, *Complexity and the Internal Revenue Code: The Problem of the Management of Tax Detail*, 34 L & Contemp Probs 673, 707 n 31 (1969) (considering merits of a general anti-avoidance statutory provision).

tem to have the advantages of reasonably simple rules without the disadvantages.

Surrey's claim is that standards allow the law to be more simple than rules do. The recent rules/standards scholarship does not make this connection. Most recent literature is not explicit about the connection between rules/standards and complexity, but much scholarship seems to treat rules as simpler than standards rather than the other way around.⁵ A notable exception is Louis Kaplow's article on rules and standards, which is explicit about the matter but treats the level of complexity as independent of the rules/standards question.⁶ I argue below that Surrey's intuition is correct. There is a connection between rules/standards and complexity, at least in the context of the tax law. In particular, standards prevent the tax law from being too complex.

Two other important features of anti-abuse rules also deserve scrutiny. First, they are one-way. They allow only the government to disregard the rules; taxpayers are bound.⁷ Second, they rely on the taxpayer's state of mind. Both these elements are controversial; the tax law could use standards without these features. These features also will be addressed below.

I take an economic approach in this Article, in that the consequences of the various approaches matter. Thus, anti-abuse rules are appropriate, compared to the alternatives, if they maximize welfare within the policymaker's constraints. This approach leaves aside rights-based approaches and, in particular, claims that taxpayers have an entitlement to rely on the literal words of the statute.⁸ In addition, this Article leaves aside issues of whether the Treasury Department has authority to issue regulatory anti-abuse rules that interpret statutes. Much of the reaction to anti-abuse rules has focused on authority, but if anti-

⁵ See, for example, Isaac Ehrlich and Richard A. Posner, *An Economic Analysis of Legal Rulemaking*, 3 *J Legal Stud* 257, 265 (1974) (arguing that rules make prediction of outcomes easier and reduce costs of the legal process); Duncan Kennedy, *Form and Substance in Private Law Adjudication*, 89 *Harv L Rev* 1685, 1687-88 (1976) (characterizing rules as determinate and standards as requiring discovery and assessment of details); Frederick Schauer, *Rules and the Rule of Law*, 14 *Harv J L & Pub Pol* 645, 646-47 (1991) (arguing that under "presumptive positivism," rule-based decisionmaking need not preclude particularistic judgments).

⁶ Louis Kaplow, *Rules versus Standards: An Economic Analysis*, 42 *Duke L J* 557, 568-88 (1992) (treating a rule and a standard that lead to identical outcomes in all cases as equally complex).

⁷ Thus, if a taxpayer accidentally steps slightly to one side of a line, the taxpayer is generally stuck with the literal result provided by the statute or regulation (although in these circumstances courts often stretch to read the statute in the taxpayer's favor).

⁸ Alan Gunn takes such an approach. See Gunn, 76 *Mich L Rev* at 735-37 (cited in note 2) (describing "the legal right" to avoid a tax). He derives such an entitlement from the case law. The case law, as far as I can tell, made the entitlement out of whole cloth.

abuse rules are desirable, authority questions merely determine which branch of government should promulgate them. These may well be difficult questions, involving constitutional issues and issues of institutional capacity, but they are secondary to the direct analysis of desirability.

Section I of the Article considers how rules and standards interact with the content of the law. Sections II and III consider, respectively, whether anti-abuse rules should be one-way and whether they should rely on purpose. Section IV identifies factors that should be considered in determining whether particular anti-abuse rules are appropriate and provides some additional remarks.

I. COMPLEX RULES, SIMPLE STANDARDS

To frame the issues raised by complex tax rules and tax avoidance, consider so-called "mixing bowl" transactions. Under current law, a partnership is not taxed as a separate entity. Instead, partners are taxed on the income of the partnership. To this end, the partnership tax rules attempt to make the partnership transparent for tax purposes. Thus, contributions to and distributions from partnerships are generally tax free.⁹

These simple rules have a huge hole. Suppose taxpayers A and B contribute their own properties to a partnership and, immediately thereafter, they each receive a distribution of the other's property. Under the partnership rules, the contribution and the distribution are both tax free. A direct exchange of the properties, however, would have been taxable under the realization rule. A and B avoided the realization rule by using a partnership to do indirectly what would have been a realization event had it been done directly.¹⁰ Most people immediately respond that

⁹ See IRC § 721 (1994) (contributions) and IRC § 731 (1994) (distributions).

¹⁰ Here is another simple example, described in Joseph Bankman, *The New Market for Corporate Tax Shelters*, 53 *Tax L Rev* (forthcoming 1999). Suppose a profitable domestic corporation would like to generate a tax loss to use against its profits. The strategy is to generate offsetting gain and loss and have the gain recognized by a nontaxable entity, such as an offshore corporation, and the loss recognized by the domestic corporation. This can be accomplished as follows. A foreign party, not subject to US tax, enters into a straddle on a currency in a country in which it does not conduct business. For example, a foreign party, domiciled and conducting business in Nation A, might enter into offsetting long and short options in the currency of Nation B. In time, one option will increase in value and one will decrease in value. Assume, for example, that each option was purchased for an amount equal to \$50 million (in US dollars) and that the gain position goes up in value to \$90 million and the loss position falls in value to \$10 million. The foreign party sells the gain position and contributes the loss position, with a basis of \$50 million and fair market value of \$10 million, to an existing subsidiary ("Sub") of the domestic corporation ("Parent"). In return, the foreign party receives nonvoting preferred stock with a

the partnership rules can't mean that. If they did, the realization rule would be meaningless, as it could be avoided at will.

The appropriate solution to this problem is not obvious. One possible response is to interpret the statute to prevent this obvious avoidance or, similarly, to pass a new law imposing such a standard. The exact content of the law would be uncertain, although, for many, if not most, transactions the law's application would be straightforward. Another possible solution would be to amend the partnership rules to describe exactly which transactions will be treated as contributions and distributions and which will not. Our tax law takes the latter approach. We now have a highly complex set of rules that distinguishes between partnership transactions and mixing bowl sales, with safe harbor periods, presumptions, exceptions, required risk allocations, allowable preferred returns, accommodation partner rules, and dozens of examples.¹¹

The problem is a rules/standards problem.¹² The usual analysis assumes that rules are simple and standards are complex.

value of, say, \$11 million. At the same time, Parent contributes an amount of cash to Sub equal to 10 percent of the value of Sub. Parent and Sub take the position that the transfers of Parent and the foreign party are governed by IRC § 351 (1994) and related provisions. Consequently, Sub takes a basis in the loss position equal to its basis in the hands of the foreign party B (\$50 million). Sub sells the position and takes a \$40 million foreign currency loss, which is ordinary rather than capital and, therefore, can be used against operating income.

It is easy to see that, if this transaction were respected, it would reduce corporate taxable income to near zero, and there are dozens of similar types of transactions. It is, however, difficult to determine the size of the market for these transactions because most transactions are not public. Bankman, who offers the most comprehensive survey of this market, estimates that corporations save about \$10 billion per year in taxes. *Id.* *Forbes*, in a recent cover story on the market for these types of shelters, estimates the growth in the industry by looking at the growth in Big Five accounting firm tax practices, which have grown at 10 percent a year—more than twice the pace of their audit practices; *Forbes* speculates that the growth is attributable to the growth in the market for tax shelters. Janet Novack and Laura Saunders, *The Hustling of X Rated Shelters*, *Forbes* 198, 206 (Dec 14, 1998).

¹¹ See IRC § 704 (c)(1)(B) (1994) and Treas Reg § 1.704.4 (treating certain distributions of contributed property as sales by partner); IRC § 707(a)(2)(B) (1994) and Treas Reg § 1.707-4, -5 (treating certain transfers to and from a partnership as sales if “properly characterized” as sales); IRC § 737 (1994) and Treas Reg § 1.737-1, -5 (calculating gain from a distribution of property to the contributing partner). Once one has the central idea of disguised sales, the imagination runs wild. For example, the properties need not be distributed. Instead, income, deductions, gain, and loss from the property that is to be sold can be allocated to the noncontributing partner. If cash is to be exchanged for property, the contributing cash can be invested in safe securities and the selling partner can receive a preferred return on the safe securities. The rules end up being quite intricate to cover all the various possibilities.

¹² There are other problems presented by this example. In particular, determining the appropriate substance of the law (for example, which transactions should be treated as sales and which should be treated as partnership transactions), regardless of whether

Rules are over and underinclusive relative to underlying norms but, because they are simple, rules are certain, easy to apply, and uniform. Standards better conform to the purpose underlying the law, but they are more uncertain and apply less uniformly.¹³

The mixing bowl example shows that contrary to the usual assumption, rules are often highly complex. I will argue below that this is typical—rather than being less complex than standards, rules must systematically be more complex than standards. The first step in the analysis was made in an important article by Louis Kaplow where he argues that rules are not necessarily less complex than standards. Contrary to the conclusions here, however, Kaplow argues that there is no connection between complexity and the use of rules or standards. This Section begins by describing Kaplow's approach and then shows how complexity and the use of rules or standards are connected.

A. Kaplow's Approach: Choosing Rules or Standards While Holding Complexity Constant

Kaplow argues that as a positive matter, the assumption that rules are simple and standards are complex is incorrect.¹⁴ Rules can be complex and highly tailored to match underlying purposes while standards are often simple. This is the case with the tax law's treatment of mixing bowl transactions. The rules are highly complex, drafted by experts in the type of transactions at issue and reviewed and commented on by hundreds of practitioners who engage in these transactions on a daily basis. While we do not know what the standard for mixing bowl transactions would have been had the tax law adopted one, it is difficult to believe that a judge or jury could make similarly nuanced distinctions or have similar knowledge of the range of transactions or the impact of their decisions. Kaplow argues that, because there is no necessary correlation between whether a law is promulgated as a rule or a standard and the actual content of the law, we should hold constant the law's content, including the level of complexity, in determining whether rules or standards are appropriate.¹⁵

done through a rule or a standard, is a serious and difficult problem. See David A. Weisbach, *Line Drawing, Doctrine, and Efficiency in the Tax Law*, 84 Cornell L J (forthcoming Sept. 1999), for an analysis of this type of problem.

¹³ See Ehrlich and Posner, 3 J Legal Stud at 265 (cited in note 5); Kennedy, 89 Harv L Rev at 1687-88 (cited in note 5); Schauer, 14 Harv J L & Pub Pol at 727 (cited in note 5); Kaplow, 42 Duke L J at 565 n 13 (cited in note 6).

¹⁴ Kaplow, 42 Duke L J at 593-96 (cited in note 6).

¹⁵ Id at 568-88.

Under Kaplow's approach, the only difference between rules and standards is whether the content of the law is determined before individuals act. If we use rules, the content of the law is determined prior to action; if we use standards, the exact content of the law is determined after action. We can assume in both cases that the content ultimately turns out to be the same. In other words, rules and standards differ in that they merely affect the level of uncertainty about the law that individuals face when they act (as well as promulgation and enforcement costs).

One could conclude under these assumptions that the mixing bowl problem should be resolved through rules. Under Kaplow's analysis, the more frequent the activity, the more likely rules should be used to govern it.¹⁶ A simplified version of Kaplow's argument is that rules have higher promulgation costs because the detailed content of the law must be determined at the time of promulgation, while standards have higher application and enforcement costs because content is determined at the time of application and enforcement.¹⁷ If the law must be applied frequently, a rule will dominate because the one-time promulgation costs of a rule will likely be less than the frequent enforcement costs of a standard.¹⁸ For example, there are millions (even hundreds of millions) of partnership contributions and distributions each year. It is surely worthwhile to decide *ex ante* which ones are sales and which ones are not. More generally, given the vast number of transactions governed by the tax law, there would be virtually no case for which the *ex ante* promulgation costs would exceed the *ex post* application costs; therefore the tax law should be promulgated almost entirely through rules. This view is common in the tax bar, where lawyers have argued in the context of anti-abuse rules that rather than use vague standards we should "confront and solve" difficult tax law problems so that "taxpayers might understand" the law.¹⁹

Although I agree with Kaplow that the assumption that rules are simple and standards are complex is wrong, I do not agree that there is no necessary correlation between the content of law and the moment at which the content is determined, at least with

¹⁶ *Id.* at 577.

¹⁷ *Id.*

¹⁸ This ignores institutional issues such as the ability of government agents to act opportunistically under rules and under standards. For example, standards in tax law might give auditing agents greater opportunities to abuse their discretion, because under standards auditors have wider latitude, and audits are typically secret while rulemaking is relatively public.

¹⁹ Ken Gideon, *Assessing the Income Tax: Transparency, Simplicity, Fairness*, 81 Tax Notes 999, 1001 (Nov 23, 1998).

respect to the tax law. There are two reasons. First, rules can less afford to overlook uncommon transactions than can standards. Rules must specify the treatment of a greater number of transactions than standards and, therefore, they are systematically more complex than standards. Second, when we use rules, small changes in transactional form often create large changes in tax liability—rules often create discontinuities. Standards in the same context do not involve similar discontinuities. A discontinuous law may have different behavioral consequences than a continuous law, and as a result, the optimal content of a rule may be different than the optimal content of a standard. Because of these two problems, we must make the rules/standards decision at the same time as we make content decisions, rather than in separate, sequential steps, as suggested by Kaplow.²⁰ We must maximize along both boundaries at once. When we do so, standards become relatively more desirable. These arguments are considered immediately below.

B. Optimal Complexity: Making the Uncommon Common

This Section argues that rules are systematically more complex than standards because rules can less afford to overlook uncommon transactions than can standards. Before giving this argument, it is worthwhile to specify more exactly the notion of complexity used here. For purposes of this Article the more complex the law, the more accurately it distinguishes between different individuals or transactions. For example, progressive rates, personal deductions, and exemptions based on family size allow us to impose tax liabilities more consistent with notions of distributive justice than a simpler law. A more complex distinction between sales and partnership transactions would more carefully categorize various transactions. We can think of this type of com-

²⁰ This reflects my reading of the thrust of Kaplow's article. His notion of a "rule equivalent to a standard" separates the choice of content from the choice of rules or standards. Kaplow, 42 *Duke L J* at 586-96 (cited in note 6). He notes that complexity and choice of rules or standards raise "two separate issues." *Id.* at 590. Elsewhere, however, he notes that there may be "synergy" between complexity and rules/standards decisions. *Id.* at 589 n 86, 595 n 101. In footnote 78, Kaplow acknowledges that we must look at both complexity and uncertainty at the same time. On page 618, Kaplow notes that the analysis for "laws regarding form" may be different than for laws regulating behavior. Conceivably the tax law falls into the form category, as it generally is not used to regulate behavior. The text reflects my reading of the main point of his article, although there are sufficient hedges in the footnotes that most problems with this position are at least noted although not incorporated into the main theory. Which approach he endorses, however, is not important to the argument in the text that complexity and the rules/standards decision cannot be separated.

plexity as the number of lines or the degree to which the lines match the underlying terrain in a topological map. Too few lines or lines that are too straight mean that the map does not provide an accurate picture of the underlying topology.²¹ Too many lines means the map is incomprehensible.

The obvious benefit of complexity is that the law will be more efficient (or more fair or more of whatever measuring stick one wants to use) than a less complex law. For example, complex law reduces under or overtaxation of particular activities relative to the desired amount as compared to simple law. Thus, if the law is too simple in distinguishing between sales and partnership transactions, it will under and overtax various transactions, creating misallocations. We must weigh the benefits of complexity against the compliance costs of complexity and balance the marginal costs and benefits.

In many contexts, there is no reason to think that rules or standards should have different levels of this type of complexity. In both cases, greater complexity better tailors the law to the underlying economics and creates greater compliance costs. This leaves us to make the rules/standards decision separately from the complexity decision; the tax law, therefore, would be promulgated mostly through rules because, as noted above, rules are appropriate when the law is applied frequently, as in the tax law.

But the tax law may be different from other areas of law in an important sense. In most areas of law (for example, the tort or safety regulations considered by Kaplow), analysis of the costs and benefits of complexity suggests that laws should be drafted to fit common circumstances. If the law fits only common circumstances, rare and unusual facts might be misregulated, but under or overdeterrence in these cases is not costly because the transactions are unusual. That is, at some point, the cost of fitting the law to rare circumstances exceeds the costs of complexity, so we don't bother. More importantly, the uncommon transactions will remain uncommon (absent changes in technology), so one may be confident in the assessment of the costs and benefits. Discussing rules and standards, Fred Schauer used as an example a candi-

²¹ An alternative notion is that complexity is caused simply by bad drafting. There may be systemic causes of bad drafting, including the failure of government drafters to internalize the costs of complexity and the existence of incentives for drafters to create complexity. This type of complexity has been studied in some detail, but the underlying political structures that cause it remain basically unchanged. See, for example, Boris I. Bittker, *Tax Reform and Tax Simplification*, 29 U Miami L Rev 1, 5-13 (1974). While complexity of this sort is worth study (and potential remedies should be adopted, if possible), I would like to leave this type of complexity aside and focus on the complexity needed to tailor the law to individual circumstances.

date for office who misses a filing deadline by three minutes; Lon Fuller used as an example a statue of a truck placed in a park where vehicles are prohibited.²² There will not be more missed filing deadlines or statues of trucks in parks merely because the rules are insufficiently complex. In an important sense, these sorts of transactions are static.

The tax law cannot adopt this approach. Uncommon transactions that are taxed inappropriately become common as taxpayers discover how to take advantage of them. This is not true in all cases in the tax law—there are places, such as the depreciation or amortization rules, where simple tax rules have not created this problem. But consider the mixing bowl example. Contributions and immediate distributions from partnerships were not common transactions when the partnership rules were drafted. The drafters clearly had in mind the normal business functioning of a partnership. The rules were insufficiently complex because they covered all contributions and distributions to partnerships, instead of a more carefully tailored set of transactions. Given time and insufficient complexity, taxpayers discovered an uncommon transaction that was mistaxed—contributions followed by immediate distributions. Uncommon transactions then became common (and even got a cute name, “mixing bowl” transactions).²³

The difference between tax law and other laws in this respect may be one of degree rather than kind. For example, underdeterred transactions will become more common in an insufficiently complex tort regime. If one type of hazardous chemical is highly regulated and a less used but similar hazardous compound is not, users will switch to the unregulated compound. Dan Kahan notes that this effect occurs in the regulation of drugs in the criminal law.²⁴ But in tax law the problem seems to be worse. One explanation might be the tax law’s focus on form, which allows taxpayers to change the application of the law to particular transactions without significantly changing their economics. Another might be

²² Frederick Schauer, *Formalism*, 97 Yale L J 509, 515 (1988) (describing the unreported case *Hunter v Norman*); Lon L. Fuller, *Positivism and Fidelity to Law—A Reply to Professor Hart*, 71 Harv L Rev 630, 663 (1958) (rebutting the claim by H.L.A. Hart that a “no vehicles in the park rule would be easy to apply without reference to the purpose of the rule”).

²³ Similarly, the transactions described in note 10 (the offshore foreign currency straddles followed by contribution of one leg to a domestic corporation) were not common at the time the rules were drafted, to say the least.

²⁴ Dan M. Kahan, *Ignorance of the Law Is an Excuse—But Only for the Virtuous*, 96 Mich L Rev 127, 138 (1997). Kahan uses as one example a criminal law listing prohibited substances by chemical composition. In response, drug sellers can alter the composition ever so slightly so that the drug produces the same effect on the users but is not on the prohibited substance list.

the culture of tax compliance, which seems to encourage manipulation.²⁵ Yet another explanation is that the tax law is not special and the analysis given here applies more generally. Whichever explanation is correct, the effect is common in the tax law.²⁶

It is inefficient for uncommon transactions to become common merely because of a tax advantage. Efficiency in the tax law is measured by whether the law raises revenue without creating adverse incentives. Inaccuracies in the tax law lose on both counts, creating adverse incentives and lowering tax revenues.²⁷ One cannot mistax uncommon transactions (for example, by having rules that are too simple) and not worry about it.

The solution in the mixing bowl context was to make the rules more complex, so that they better reflected the underlying norms.²⁸ They now carefully distinguish between partnership transactions and mixing bowl sales. But rules are not good at regulating infrequent transactions because their content must be determined *ex ante*. If there are 1,000 possible rare transactions, and only 10 actually will occur absent the opportunity to evade taxes, rules must anticipate all 1,000 transactions and do so accurately.

Standards would have been less complex because they would not have had to anticipate each and every situation that might arise in the future. A standard needs to be given content only for those sets of facts, the 10 of the 1,000, that actually occur. The content of the law for the other 990 remains open, which means

²⁵ This culture arguably stems from a long history of court decisions blessing tax avoidance schemes. See, for example, cases cited in Marvin A. Chirelstein, *Learned Hand's Contribution to the Law of Tax Avoidance*, 77 Yale L J 440, 441 (1968) ("More perhaps than any other single judge or commentator, Learned Hand was instrumental in the development of [judicial approval of tax avoidance]."). Perhaps the most famous statement to this effect is in *Helvering v Gregory*, 69 F2d 809, 810 (2d Cir 1934) ("[A] transaction, otherwise within an exception of the tax law, does not lose its immunity, because it is actuated by a desire to avoid, or, if one choose, to evade, taxation. Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes."), *affd*, 293 US 465 (1935). Using a dangerous chemical that somehow managed to escape regulation or altering an illegal drug to avoid prohibition would not be viewed with similar heroism.

²⁶ See Bankman, 53 Tax L Rev (forthcoming 1999) (cited in note 10), and Novack and Saunders, *The Hustling*, *Forbes* at 199 (cited in note) (noting that the corporate tax shelter "business is booming").

²⁷ The revenue losses may be enormous. As noted above, Bankman argues that the losses are as high as \$10 billion per year. See Bankman, 53 Tax L Rev (forthcoming 1999) (cited in note 10).

²⁸ This is not to say that the regulations are purely rule-based. Like most laws, they include some mix of rules and standards, but on a relative basis, they are very rule-like.

that overall the law is less complex. In other words, because when standards are used the content of the law is determined after taxpayers act, there will be fewer opportunities for taxpayers to take advantage of imperfections in the law. This means that the other 990 transactions, some of which would have occurred under insufficiently complex rules, will not occur under a standard. If the law is promulgated as a standard, at a lower level of complexity the uncommon will not become common. Therefore, tax rules must be more complex than tax standards.

One may still conclude that the tax law should be promulgated as rules, albeit complex ones. After all, most tax laws still apply to millions of transactions. Unfortunately, however, when rules become highly complex, they tend to remain subject to the “uncommon becoming common” problem because of “interaction” costs. Interaction costs are the costs of ensuring that the various provisions of the law work together—that they do not conflict or have unintended gaps or loopholes. The more complex tax law gets, the greater the number of interactions among the rules and the more complex the law must be. The number of interactions is approximately proportional to the square of the number of rules,²⁹ and as complexity increases, interaction costs quickly become intolerable. If unusual transactions stay unusual, odd interactions between rules can be ignored. But in the tax context the law must anticipate all of the interactions, even for rare transactions. Otherwise, rare transactions will become frequent as taxpayers discover the tax benefits. Thus, as tax rules become complex, interaction costs increase rapidly and rules quickly become unmanageable. Because standards are less complex, their interaction costs are lower, which avoids the vicious cycle created by complex rules.

Another way to articulate the rules/standards problem in the tax law is to note that rules apply to their complete domain even if at the borders they are inaccurate. This type of inaccuracy makes an easy target for tax planning, which both loses revenue and distorts transactions. To reduce this potential, rules must become more complex, and greater complexity creates additional opportunities for planning, and onward and onward. Standards are fuzzy at the borders, reducing this problem.³⁰

²⁹ If we have n rules in existence and we add a new rule, the new rule must interact with all n prior rules. A second new rule would have to interact with $n+1$ prior rules.

³⁰ This point is similar to the argument made frequently that rules will be under and overinclusive relative to their purposes. That a rule may be more complex than a standard, in the sense used here and by Kaplow, yet still be more under and overinclusive than a standard, indicates that there is more than one notion of complexity being used.

Thus, the optimal complexity of tax rules is greater than the optimal complexity of tax standards, and therefore, whether we use rules or standards affects the content of the law. We must maximize along both boundaries—whether to use rules or standards and the content of the law—at once. While such a maximization problem is difficult, adding complexity to the analysis pushes in only one direction, toward more standards. This is not to say that the tax law necessarily should use a lot of standards. The frequency analysis suggested by Kaplow still may dictate many rules. But a more complete analysis will dictate fewer rules than the frequency analysis standing alone.

C. Consequences of the Discontinuity of Rules: Tax Arbitrage

The second problem with separating the content of the law from the rules/standards decision—the discontinuity of rules—is best illustrated by an example. In mixing bowl transactions, the government faced the problem of distinguishing between essentially identical transactions. On one side, there was the paradigmatic partnership transaction, which was tax free. On the other side, there was a typical sale or exchange, which was taxable. Between these extremes was a continuous range of transactions, and the policymaker had to decide which were taxable and which were not. This type of problem is quite general in the tax law. The tax law distinguishes between debt and equity, selling and holding, and independent contractors and employees. There are hundreds of these types of distinctions. Typically, the tax law must, on some basis, choose between the two extremes rather than characterize transactions in the middle as part of each.

Suppose we have some notion of where the correct dividing line is and must decide whether to promulgate the line as a rule or a standard.³¹ No matter how nuanced a rule is, it will create a bright line between the two types of transactions. Moving one

The notion of complexity used here is the number or detail of distinctions made by the law, particularly as applied to common sets of facts. The notion used elsewhere in discussions of rules and standards is the ability to deal with the odd case. It is possible that a rule might be highly complex but still not deal properly with the odd case while a standard might be quite simple but readily handle odd cases. Kaplow is correct that in most areas of the law, focusing on standards' ability to deal with the odd case ignores more important issues—the daily transactions regulated by law. The argument made in the text is that rules in the tax law cannot ignore the odd case and, therefore, standards become relatively more desirable.

³¹ See Weisbach, 84 *Cornell L J* (forthcoming Sept 1999) (cited in note 12) (discussing how best to decide where the line should be drawn).

step to the left will cause a large change in tax consequences. In this sense, rules are discontinuous.³²

Standards, *ex post*, have the same discontinuity. A marginal change to a transaction can change the application of the law. The courts or administrators who give content to standards have no greater ability to avoid the line drawing problem than Congress or the regulators who give content to rules. But *ex ante*, the taxpayer only knows probabilities. A small change in facts will only change the probability a little, creating a continuous change in the law from an *ex ante* perspective.

A discontinuous law, a cliff, may have very different behavioral effects than a continuous law, although one cannot say which will be more efficient without more information. For example, if the tax law required assets to remain in the partnership for two years prior to distribution to avoid disguised sale treatment, taxpayers who gain more from avoiding sale treatment than they lose by waiting two years will shift their behavior to use partnerships rather than sales. Those who would have waited two years anyway have no costs imposed on them. Those who would have waited a year and six months have the costs of a six month wait imposed on them, and those who never would have used a partnership at all have the costs of a two year wait. The deadweight loss is the cost of the wait we impose on these taxpayers (measured relative to the tax revenue raised by this rule).

If instead we impose a standard whose expected value is two years but the content of which is highly uncertain, each additional day in the partnership produces a tax savings. This means that everyone has an incentive to leave properties in partnerships a little longer. Even those who would have waited two years anyway might extend the time. But the benefits of extending the time come in small, daily increments. Taxpayers will extend the time property remains in the partnership until the costs exceed the benefits. The total amount of shifting may be more or less than in the bright line case, depending on the costs of shifting and, without more information, we cannot tell which is the case.

More generally, rules will tend to be discontinuous while standards will not. Where there is a discontinuity, taxpayers sufficiently near the discontinuity will shift to the lower taxed re-

³² Technically, a tax system is continuous with respect to a transaction if, for any transaction (or position) and any positive number (no matter how small), one can choose a set of transactions surrounding the transaction such that the tax treatment of each transaction in the range differs from the tax treatment of the original transaction by less than the chosen number. See Jeff Strnad, *Taxing New Financial Products: A Conceptual Framework*, 46 *Stan L. Rev.* 569, 597-98 n 80 (1994), for a discussion of continuity.

gime, if transaction costs are less than the tax savings. The deadweight loss will be the sum of the losses from this shifting. When the law changes continuously, there is no particular line that the shifting centers around. All taxpayers potentially benefit from shifting. Each taxpayer will alter her behavior so that the expected tax savings just exceed transactions costs. The total amount of shifting will depend on how rapidly the law changes relative to the transaction costs of shifting.

There is no reason to expect the deadweight losses in these cases to be the same. But because the efficiency costs of a rule with a given content may be different than the costs of a standard with the same content, the optimal content for a rule may be different than the optimal content for a standard, which means the content of the law and the rules/standards decision interact.³³

A different sort of behavioral change might cause one to conclude that standards are preferable. Consider a tax system that is discontinuous. The tax treatment of a transaction changes abruptly at some point. Taxpayers can achieve a tax arbitrage by matching a long position very close to that point with a short position exactly at that point. While the pretax net cash flow from these two positions can be made arbitrarily close to zero, the investor will experience a significant net tax effect.³⁴

Taxpayers cannot achieve this type of arbitrage in the mixing bowl context as there is no simple way to take a short position in the transaction. But in the financial context, short positions will exist and arbitrage will be cheap. The classic example of this is

³³ The effect of discontinuities in the law has been discussed, among other places, in John E. Calfee and Richard Craswell, *Some Effects of Uncertainty on Compliance with Legal Standards*, 70 Va L Rev 965, 974-89 (1984) (discussing uncertainty and the negligence standard). See also Saul Levmore, *Probabilistic Recoveries, Restitution and Recurring Wrongs*, 19 J Legal Stud 691 (1990).

³⁴ Tax arbitrage as used here is so-called "pure" tax arbitrage, which involves buying and selling the same asset in different forms. See Eugene Steuerle, *Tax Arbitrage, Inflation, and the Taxation of Interest Payments and Receipts*, 30 Wayne L Rev 991, 1004-05 (1984). Pure tax arbitrage, as defined by Steuerle, will not change the price of the asset as the demand is not changed by the activity (it is bought and sold at the same time). If the two assets used in the arbitrage are different, the arbitrage might change the price of the assets, capitalizing the tax benefit into the price. This might be efficient, for example, if Congress enacted a tax preference, the workings of which are dependent on capitalization. Tax exempt bonds are the classic case, where arbitrage might lower the interest rate on the bonds by capitalizing the tax benefit into the price, thereby helping municipalities, the intended beneficiary of the exemption. The arbitrages from discontinuous rules are not typically incentives enacted by Congress. Instead, they are unintended results and there is no reason to think that capitalization would be efficient, as it will lead to over or under-supply of the asset. It is possible that the price changes induced will offset some other inefficient price changes caused by taxes or some other regulation so that two wrongs might be better than one, but absent some evidence of this in a particular situation, we should not be paralyzed by such second-best considerations.

the *Knetsch* case,³⁵ in which the taxpayer purchased an annuity with money borrowed from the same company that sold the annuity.³⁶ The borrowing (the short position) produced immediate interest deductions while the annuity (the long position) had deferred interest inclusions.³⁷ Little or no cash changed hands, but the taxpayer generated significant tax losses.

Tax arbitrage is inefficient. If the forms used in the arbitrage are perfect substitutes, there is no economic cost to the arbitrage; the social costs are the transaction costs, which can be large—as large as the tax avoided. If the forms are not perfect substitutes, taxpayers change their economic position to obtain a tax advantage, creating inefficiencies similar to the inefficiencies generated by insufficiently complex tax laws. For example, the taxpayer in *Knetsch* might have borne risk in order to show that the transaction was not a complete sham. This increases the return to bearing risk, creating an incentive to take on risk.

The discontinuities created by rules, therefore, have consequences for the content of the law. Rules allow more arbitrages and, therefore, rulemakers will have to adjust content to take into account the effect of the arbitrages. At a minimum, if arbitrages lose tax revenue, the tax system will have to raise the money elsewhere. Aside from arbitrage, the effect of discontinuous laws on taxpayer behavior is ambiguous, but it is likely to have effects, and content will have to be adjusted accordingly. This means that we must make the rules/standards decision and the content decision at the same time. And once again, simultaneous maximization will be complex but, given the problems with arbitrage, will often push in the direction of standards.

D. A Possible Solution: Anti-Abuse Rules

Arguments for more standards in the tax law are contrary to the common reaction that we should be certain of our tax liabilities.³⁸ I am not sure of the source of this intuition, but it makes

³⁵ *Knetsch v United States*, 364 US 361 (1960).

³⁶ *Id.* at 362-64 (holding that interest paid on debt was not deductible when debt was a sham to decrease tax liability).

³⁷ The life insurance company, however, had symmetric treatment of the borrowing and the annuity because of its ability to claim reserves, which meant that it did not have income to offset *Knetsch's* deductions. See IRC §§ 807 (1994) (allowing life insurance companies to claim deductions for reserves), 816 (1994) (defining reserves).

³⁸ But see Joseph Stiglitz, *The New, New Welfare Economics*, in Allen J. Auerbach and Martin Feldstein, eds, *Handbook of Public Economics* 1001, 1011-13 (Elsevier Science 1987), for an argument that random taxation may be efficient under certain conditions. Retroactive taxes may also introduce uncertainty and prevent or limit the problem of uncommon transactions becoming common. A rule-based regime that used retroactive taxes,

little sense. There is no reason that the tax law should be more certain than other areas of law. For example, it seems odd to suggest that we should be more certain of our tax liabilities than our constitutional rights, which is a largely standards-based area of law, or criminal sanctions, which may depend on the discretion of the judge.

This is not to say that uncertainty in the tax law is desirable in its own right. Given the frequency of transactions governed by tax law, rules are highly desirable. A pure standards-based approach to tax law would not be workable. But the cost of rules is also too high, as they must be unduly complex. The analysis leaves us between the Scylla of certain but unduly complex rules and the Charybdis of uncertain but less complex standards. The goal of anti-abuse rules is to find a way out.

Anti-abuse rules, as suggested by Surrey thirty years ago (in the context of court-imposed anti-abuse rules), attempt to allow the tax law to use simple rules without all of the associated costs.³⁹ They create fuzzy rules. For example, in crafting a tax law that includes an anti-abuse rule, drafters need not be terribly concerned with rare transactions that might be mistaxed because attempts to take advantage of them will be covered by the anti-abuse rule. In addition, while not completely solving the line drawing problem created by discontinuous rules, they reduce arbitrage around the discontinuities. We can then make the decision to use rules or standards or to promulgate the law at a given level of complexity based on the usual considerations, with less regard to uncommon transactions or arbitrages created by discontinuities.

The strategy suggested here of obtaining the benefits of rules without some of the costs can be pursued in a number of different ways. A common approach is a list of cases covering known situations and a catch-all category for other cases. For example, a casualty loss is defined as a loss from "fire, storm, shipwreck, or other casualty."⁴⁰ Another approach is to promulgate a standard but include examples of the application of the standard to com-

therefore, might be an appropriate solution to the problem. Given Congress's reluctance to impose retroactive taxes, I will treat this option as unavailable. See Saul Levmore, *The Case for Retroactive Taxation*, 22 *J Legal Stud* 265, 273-78 (1993) (discussing merits of retroactive taxation).

³⁹ Surrey, 34 *L & Contemp Probs* at 707 n 31 (cited in note 4) (noting that anti-abuse rules "save the tax system from [] far greater proliferation of detail").

⁴⁰ IRC § 165(c)(3) (1994).

mon situations.⁴¹ A third approach is to provide a standard with safe harbors.⁴²

All these approaches attempt to provide some of the certainty of rules with some of the flexibility of standards to cover unknown situations. Anti-abuse rules have at least two other features that make them unique: they are one-way in favor of the government and they depend on state of mind. This question of which approach is best is taken up below, although the fate of anti-abuse rules in particular is less important than the need to use strategies that combine the benefits of rules and standards.

II. ONE-WAY LAWS

Anti-abuse rules allow only the government to depart from the literal language of the law. If the law provides an inappropriate result for the taxpayer, the taxpayer is stuck. Anti-abuse rules take a "heads I win, tails you lose" approach. Other approaches to the rules/standards/complexity problem discussed above, such as lists or standards with examples, do not have this feature. The question is whether one-way rules are appropriate in this context, given the alternative methods of solving the problem.

The burden of proof in favor of one-way rules ought to be high. They create an appearance of unfairness because the government uses different rules than the taxpayer. If a result is inappropriate for the government, one would think it would be inappropriate for the taxpayer.

Nevertheless, one-way rules are common in the tax law. For example, there are many rules deferring losses (which helps the government) but taxing gains (which hurts the taxpayer) on the same type of transaction.⁴³ And traditional court-based anti-abuse principles were always one-way in favor of the government.⁴⁴

⁴¹ The most important recent case of this approach is the rules governing transactions between members of a consolidated group. See Treas Reg § 1.1502-13.

⁴² For example, for a merger to be tax free, an uncertain portion of the consideration to the target corporation shareholders must be stock of the acquiring corporation to create so-called "continuity of interest." See Treas Reg § 1.368-1(b). The appropriate level of stock consideration is a standard but the IRS has promulgated a safe harbor such that, if 50 percent of the consideration is stock, continuity of interest has been met. Rev Proc 77-37, 1977-2 Cum Bull 568, 569. See also Cass R. Sunstein, *Problems with Rules*, 83 Cal L Rev 953, 960-68 (1995), for a description of other approaches to the rules/standards problem.

⁴³ See, for example, IRC § 267 (1994) (sales to related parties), § 1091 (1994) (wash sales), and § 1092 (1994) (straddles). There are also many rules taxing gains but not losses. See, for example, the rules for boot in IRC § 351 (contributions to a controlled corporation) and § 1031 (like kind exchanges).

⁴⁴ See Michael E. Baillif, *The Return Consistency Rule: A Proposal for Resolving the Substance-Form Debate*, 48 Tax Law 289, 300 (1995) (noting that "the so called 'two-way

Anti-abuse rules do not introduce anything new. While this is not a justification, it indicates that there might be something systemic in the tax law that creates a need for one-way rules.

The best argument for one-way rules is that they produce a level playing field despite the bias on their face. Think of tax law promulgation as a game. The government has the first move, in which it must determine the content of the law. The taxpayer then determines her transactions. The government has the pen; the taxpayer has the plan. Given this game, the taxpayer has a distinct advantage over the government, because the taxpayer acts with complete knowledge of the government's decisions while the government can only guess at the taxpayer's decisions.⁴⁵ One-way rules level the playing field by reducing the taxpayer's ability to take advantage of the situation.

For example, capital gains are taxed when realized; the use of capital losses, however, is severely restricted, creating an apparent one-way rule in favor of the government. But taxpayers can choose when to recognize gain or loss. Generally they defer gains while accelerating losses. Data show that, because of the deferral, gains are taxed at a significantly lower effective rate than losses.⁴⁶ The capital loss restrictions attempt to level the playing field by deferring losses until gains are realized. Thus an apparent one-way rule against the taxpayer only levels (in this case not even levels) the playing field.

In this general form, the "level playing field" argument simply restates the problems with a pure rules-based tax law. If the government moves first through rules, taxpayers can take advantage of gaps in the rules. Arguably, the same benefit could be achieved with standards or lists. The government could reduce its first mover disadvantage by effectively refusing to move first by using standards (the content of which is determined only after the taxpayer has acted) or moving first only where it is sure of the consequences (by using lists, safe harbors, or standards with examples of clear cases).

The distinct advantage of one-way rules is that they retain the advantages of rules in all but narrow circumstances. That is, suppose that, but for the problem with uncommon transactions

street' [of symmetric application of court-created anti-abuse rules] seems to run downhill for the [IRS] and uphill for the taxpayer").

⁴⁵ I can remember sitting in government offices for hours on end trying to imagine what the taxpayer response would be to a given set of rules so that we could draft the rules around the anticipated response.

⁴⁶ See Calvin H. Johnson, *Deferring Tax Losses With an Expanded § 1211*, 48 *Tax L. Rev.* 719, 723 (1993).

becoming common, we would promulgate the tax law almost exclusively through rules. One-way rules help us do this by enabling us to enter into a bargain in which taxpayers get rules so long as uncommon transactions stay that way. In normal circumstances, where taxpayers are going about their everyday business, both the government and the taxpayers are bound by the usual rules. But when a transaction takes advantage of simple rules and breaks the implicit pact that uncommon transactions not become common, an anti-abuse rule enforces the bargain.

Whether anti-abuse rules retain the benefits of rules depends on how well targeted they are, on how well they enforce the bargain. If they apply only in the targeted cases, where the unusual becomes usual, they may well retain the benefits of rules and reduce the number of uncommon transactions that become common. If, however, they create uncertainty outside their intended scope, they may have no advantage over other approaches.

One-way laws promulgated as rules inevitably miss their target to some extent. For example, the capital loss regime applies to all capital losses even if the taxpayer has not selectively realized losses or has true economic loss. Anti-abuse rules attempt to tailor their focus more narrowly than the capital loss regime. To do so they look at purpose. They apply only when the transaction is structured with a purpose of avoiding the purposes of the statute. The question is whether looking at purpose sufficiently narrows the scope of anti-abuse rules so that they are a better solution to the rules/standards/complexity problem than other approaches, or whether anti-abuse rules produce such uncertainty and are so frequently misapplied that the costs of using them are higher than those of other approaches. This is taken up immediately below.

III. PURPOSE-BASED TAXATION

Whether anti-abuse provisions should be used in the tax law comes down to the degree of uncertainty they create. If they are not more certain than other approaches to solving the rules/standards/complexity problem, they are undesirable (although other solutions to the problem, such as more standards in the tax law, would remain desirable). If they are more certain, they are desirable.

As noted above, anti-abuse rules focus on two distinct purposes. They typically apply only to transactions entered into with

a purpose of avoiding the purposes of the statute.⁴⁷ The taxpayer's purpose and the lawmaker's purpose are both relevant.

Before examining the specifics of this approach, one might object to any taxation based on the taxpayer's state of mind; the notion of income does not (most often) rely on the taxpayer's thoughts. One might think it offensive to tax two individuals with the same Haig-Simons income differently because one of them has had evil thoughts.⁴⁸ Case law generally supports the proposition that state of mind is irrelevant.⁴⁹

Nevertheless, from a welfarist perspective, the taxpayer's state of mind might very well be relevant. For example, ability taxation, which would depend on innate or unobservable factors like state of mind, would be more efficient than income taxation because it would not be avoidable and therefore would not create adverse incentives. We cannot reject state of mind taxation merely because definitions of income do not rely on purpose.

The problem with looking to the state of mind is feasibility. Until we invent a mind reading machine, we cannot accurately determine state of mind. Instead, we look to external, objective evidence to guess at state of mind. Whether we should rely on this evidence to determine taxation is merely a question of the costs and benefits and of the accuracy of proxies for true state of mind.

The goal of anti-abuse rules is to identify violations of the implicit pact that uncommon transactions will not become common in response to simple rules. To identify these transactions, anti-abuse rules look at both the taxpayer's purpose and the purpose behind the statute. The statute's purpose is relevant because it allows us to identify which transactions the drafters contemplated in designing the simple rules and which they did not; that is, which transactions were sufficiently common to be considered when the law was promulgated. We look to the taxpayer's purpose to determine whether the reason for the transaction is to

⁴⁷ See note 1.

⁴⁸ The leading article in this tradition is Walter Blum, *Motive, Intent, and Purpose in Federal Income Taxation*, 34 U Chi L Rev 485 (1967) (arguing against the use of states of mind in the tax law). See also Gunn, 76 Mich L Rev at 743-58 (cited in note 2) (criticizing courts distinguishing between taxpayers based on motivation).

⁴⁹ See, for example, *Superior Oil Co v Mississippi*, 280 US 390, 395-96 (1930) (opinion by Holmes) ("The only purpose of the [taxpayer] was to escape taxation. . . . The fact that it desired to evade the law, as it is called, is immaterial, because the very meaning of a line in the law is that you may intentionally go as close to it as you can if you do not pass it."). See also *Helvering v Gregory*, 69 F2d 809, 810 (2d Cir 1934) ("[A] transaction otherwise within the exception of the tax law, does not lose its immunity, because it is actuated by a desire to avoid . . . taxation."), *affd*, 293 US 465 (1925).

take advantage of the simple rules. If we applied the anti-abuse rules to all unusual transactions, the rules would be overbroad, because unusual transactions may be perfectly legitimate and the existence of some unusual transactions is to be expected. And if we applied anti-abuse rules to all transactions planned with taxes in mind, the rules would be overbroad. The government may very well draft rules with the intent that there be some taxpayer planning, resulting from some imperfection in the taxation of common transactions that taxpayers are expected to exploit. Instead, we must identify uncommon transactions that become common because of simple rules. We can do so only by looking to purpose.

Purpose, of course, can only be guessed at through objective evidence. We might look to see if the transaction is unusual, whether it offers significant tax benefits, whether it is consistent with the business (in other words, whether there is a business purpose), and whether the individual steps in the transaction make sense. Anti-abuse rules could refer to this type of objective evidence or directly to the taxpayer's state of mind; it does not really matter which. Similarly, rather than look to congressional purpose, we can look to the types of transactions that were common at the time of enactment and the problems or issues that led to enactment. Again, it does not matter which; we always use proxies to determine purpose.⁵⁰

Thus, the goals of purpose-based anti-abuse rules seem plausible. The question is, compared to the level of uncertainty created by anti-abuse rules, what level of uncertainty do other resolutions of the rules/standards/complexity problem create? It is difficult to evaluate the level of uncertainty, as it will vary with the context. There are many anecdotal stories but no real data. My own intuition is that most anti-abuse rules do not create significant uncertainty, although the level of uncertainty will vary. I believe Dan Halperin's claim that tax lawyers are sufficiently trained and share a sufficiently common understanding of the tax law to be able to determine which transactions anti-abuse rules target and which they do not.⁵¹ Moreover, the highest uncertainty

⁵⁰ Some have argued that the notion of legislative purpose may be nonsensical. See Max Radin, *Statutory Interpretation*, 43 Harv L Rev 863 (1930). While scholars can debate this issue, it is not difficult to see that mixing bowl transactions, in their purest form (in other words, contribution and immediate distribution), are inconsistent with the purpose of the statute.

⁵¹ Daniel Halperin, *Are Anti-Abuse Rules Appropriate?*, 48 Tax Law 807, 809 (1995) ("I believe that sophisticated practitioners are undoubtedly aware when a transaction is structured to achieve a tax result inconsistent with its economic substance.").

is reserved for transactions that are most likely to be inefficient. A transaction entered into without regard for the tax system, for a true business purpose, is not likely to face any significant uncertainty because of anti-abuse rules. Thus, I conclude that anti-abuse rules retain the benefits of rules while reducing the problems created by rules better than other approaches to the issue.

IV. OTHER COMMENTS

A. When Are Anti-Abuse Rules Appropriate?

The discussion above took a blanket approach to anti-abuse rules and did not consider factors that might bear on individual cases. Anti-abuse rules will be more appropriate in some cases than in others. From the discussion above, it is apparent what factors determine when anti-abuse rules are appropriate.

First, anti-abuse rules are designed to allow simpler rules. Where complex rules have been enacted, it is not appropriate to add an anti-abuse rule on top of the complex rules. This is, I believe, the underlying cause of the complaints about the partnership anti-abuse rule, a *cause célèbre* in the tax world for a number of years. The partnership anti-abuse rule came after repeated amendments to the partnership statute intended to prevent transactions such as the mixing bowl transaction.⁵² It applied in addition to all of the complex rules and overrode the rules. In this case we might have the worst of both worlds—unbelievably complex rules *and* uncertainty. A better approach would have been to propose the partnership anti-abuse rule in exchange for repeal of many of the complex rules.⁵³

Second, anti-abuse rules are appropriate only where the problems of simple rules are serious. In many cases, simple rules work well, particularly where avoiding the rule requires a real

⁵² For example, the disguised sales rules in IRC §§ 704(c)(1)(B), 707(a)(2)(B), and 737 arguably would not have been needed if an appropriate anti-abuse rule had been enacted first. An anti-abuse rule on top of the complex statutory rules, however, creates uncertainty without all of the benefits of anti-abuse rules.

⁵³ Whether a given set of rules is complex or not depends on the economics of the underlying transactions and on the ability of taxpayers to manipulate the rules. For example, the rules governing the taxation of debt instruments (the OID rules) found in sections 1271-75 of the Code are often thought of as complex. If the rules are complex, the OID anti-abuse rule may not be appropriate, as it creates a layering effect of complexity and uncertainty. But the OID rules might not be complex relative to the underlying economics, and rules sufficiently complex to stand on their own may have been significantly more complex than rules layered with the anti-abuse rule. One cannot merely look at the surface level of detail to determine whether a given set of rules is complex and, therefore, we cannot conclude that the OID anti-abuse rule is undesirable merely because the regulations appear complex.

change in behavior rather than just a change in form. For example, the tax law relies on large asset classes to determine appropriate depreciable lives. Simple rules in this case have been very effective and have not caused problems. The rules for determining when a couple is married are simple—if you are married on the last day of the year, you are married. These rules, while allowing some manipulation, do not create serious problems. It is important to find simple compromises like this, and anti-abuse rules should not get in the way.

Third, the level of uncertainty created by an anti-abuse rule will vary with the context. For example, some have argued that the corporate tax rules are without purpose. One can only apply them as a formal system. If the argument is correct (and I am not sure that it is), the level of uncertainty created by an anti-abuse rule would be large, because references to the purposes of the statute would be highly ambiguous. The benefits in this case may not outweigh the costs.

Finally, anti-abuse rules should be used only where effective. If an anti-abuse rule is not likely to prevent taxpayers from taking advantage of insufficiently complex rules, other approaches to the problem are needed. For example, an approach that relies less on rules, such as standards with examples, might work better. This brings us to the next topic, which is when anti-abuse rules are likely to be effective.

B. Efficacy

Anti-abuse rules are not appropriate if they do not adequately enforce the implicit bargain, that is, if they do not prevent taxpayers from taking advantage of simple rules. If anti-abuse rules are not effective, they add uncertainty without the offsetting benefits.

We can view the tax manager of a business as a portfolio manager. The manager does not care about any particular position. Instead, he wants a diversified portfolio that creates the desired return for the risk. The tax manager's return is the effective tax rate; the risk is the risk that the true rate, determined after audit, will be higher than the expected rate. Anti-abuse rules operate by increasing the risk of transactions explicitly designed to lower effective tax rates (relative to a pure, rules-based regime).

If there are a large number of transactions with a given risk and return, it will be ineffective to promulgate the law to respond to any particular transaction, such as a targeted anti-abuse rule. Managers will simply shift their portfolio to other positions and maintain their risk/return position, much like stock portfolio

managers would simply adjust a portfolio if IBM suddenly became significantly riskier. For anti-abuse rules to be effective, they must apply to a broad set of transactions so as to increase the risk of aggressive transactions.

This suggests that reading anti-abuse principles into tax statutes is an appropriate method of implementing anti-abuse rules. If all tax statutes contained an implicit anti-abuse rule, risk would be increased for all transactions, preventing tax managers from shifting their portfolios.⁵⁴ The only problem with such a principle is that, as discussed above, anti-abuse rules can be more or less appropriate for various circumstances and courts might be very inaccurate in determining when they should apply.

C. Other Areas of the Law

Anti-abuse rules, at least in the form they take in the tax law, appear to be concentrated heavily in the tax area. After some searching, I found that only the securities law has more than an isolated anti-abuse rule, and even the securities law has only a few.⁵⁵ The question is why only the tax law has taken this approach.

The answer seems to be that other areas of law often use a similar strategy but simply do not use the anti-abuse language of the tax law. For example, Dan Kahan observes the same approach in the criminal law, which he argues uses “*prudent obfuscation* of the law’s outer boundary” to prevent exactly the type of problem discussed here.⁵⁶ Contract law has a duty of good faith,

⁵⁴ This leaves aside issues of separation of powers that often play an important role in statutory interpretation.

⁵⁵ The regulations underlying the federal securities laws contain at least five anti-abuse provisions. 17 CFR § 230 Prelim Note 2 to Reg S (1998) (denying Regulation S exemption for foreign transactions to “any transaction or series of transactions that, although in technical compliance with these rules, is part of a plan or scheme to evade the registration provisions of the [Securities Act of 1933]”); 17 CFR § 230 Prelim Note 6 to Reg D (1998) (denying Regulation D exemptions in same circumstances); 17 CFR § 230.144A Prelim Note 3 (1998) (denying Rule 144A exemption for sales to qualified institutional buyers in same circumstances); 17 CFR § 230.147 Prelim Note 3 (1998) (denying Rule 147 exemption for offers of securities in only one state in same circumstances); 17 CFR § 240.12g5-1(b)(3) (1998) (addressing securities held in a form “used primarily to circumvent” the reporting provisions of the Securities Exchange Act). An extensive (but by no means comprehensive) search of US statutes and regulations revealed only sporadic anti-abuse rules in other areas. See 7 CFR § 718.201(d) (1998) (denying approval to farm reconstitutions that otherwise meet regulatory criteria if the primary purpose of the reconstitution is to circumvent agriculture regulations); 19 CFR § 10.304(b) (1998) (denying preferential “originating goods” status under US-Canada Free Trade Agreement to goods “having undergone any process or work in which . . . the sole object was to circumvent the provisions of [the US-Canada Free Trade Agreement]”).

⁵⁶ Kahan, 96 Mich L Rev at 139 (cited in note 24).

which can override the literal language of the contract.⁵⁷ And state traffic laws may require reasonable or cautious driving even if the driver complies with the explicit rules.⁵⁸ The interaction of the content of the law with the promulgation of the law as a rule or a standard appears to be a relatively common phenomenon.

One might ask, if the problem is common, why has the tax law had to address it more explicitly than other areas of law. It may be that the problem of uncommon transactions becoming common is worse in the tax law than in other areas. The tax law relies on form more than most areas of the law, and one can easily manipulate form without changing the economics of a transaction. In addition, taxpayers often feel entitled to structure transactions to avoid taxes,⁵⁹ an entitlement that has its origins in a long and distinguished line of case law. This type of entitlement may encourage taxpayers to push the boundaries, requiring a more explicit response in the tax area than in other areas.

D. Public Choice Elements

The discussion above treats the decision to impose an anti-abuse rule as one made by a decisionmaker attempting to maximize welfare. Actual lawmakers often have other incentives. The prevalence of anti-abuse rules may reflect some of their incentives as well as welfare maximization. In particular, anti-abuse rules shift power to government policymakers by retaining discretion in the application of the law. A countervailing incentive, however, is to promulgate complex rules, as regulators often leave the government and become practicing lawyers. Complex rules create a demand for the drafter's legal advice as the drafter is likely to have a better knowledge of the law than others. Given these incentives, there is no reason to believe that the government will promulgate the law in the optimal form, but it is difficult to make a prediction which way the bias goes.

⁵⁷ While there is a long line of cases in the tax law implementing anti-abuse principles, there are as many cases insisting on literal interpretation of the Code. See note 25.

⁵⁸ For example, in addition to specific speed limits, Illinois law provides:

No vehicle may be driven upon any highway of this State at a speed which is greater than is reasonable and proper with regard to traffic conditions and the use of the highway, or endangers the safety of any person or property. The fact that the speed of a vehicle does not exceed the applicable maximum speed limit does not relieve the driver from the duty to decrease speed when . . . special hazard exists with respect to pedestrians or other traffic or by reason of weather or highway conditions.

ILCS ch 625, § 5/11-601(a) (Michie 1993).

⁵⁹ See note 25.

E. Norms

I would be remiss in a Symposium at The University of Chicago Law School in the 1990s not to mention norms. One may view anti-abuse rules as an attempt to change the norms among taxpayers. As noted above, much case law gives credence to the idea that we should encourage planning bizarre transactions solely to minimize taxes. In an attempt to change norms among taxpayers, anti-abuse rules may simply express the contrary view, that such planning is unacceptable. Learned Hand and other judicial promoters of tax shelters were wrong. Tax motivated transactions are inefficient and, by lowering tax receipts, they impose an externality on everyone else in the form of higher tax rates. Norms that such transactions are unacceptable might reduce their prevalence.

CONCLUSION

While anti-abuse rules are, for now, a tax law phenomenon, they point to an important problem in the rules/standards decision that may occur in other areas of the law: the level of complexity and the decision to use a rule or a standard interact. Rules must be promulgated in advance and, therefore, have to cover all possible transactions. If misregulating uncommon transactions creates high costs, as in the tax law, rules must be more complex than standards. This makes the choice between the two more complicated. At a minimum, literature on the rules/standards distinction should make clear the assumptions concerning the connection between rules, standards, and complexity. Within the tax law, mistaxing uncommon transactions often creates serious problems, yet given the frequency of application, rules are needed. Anti-abuse rules, by creating "fuzzy rules," attempt to solve this problem.