The Cost of Norms: Tax Effects of Tacit Understandings

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Most human interactions take place in reliance on tacit understandings, customary practices, and other legally unenforceable agreements. A considerable literature studying these informal arrangements (commonly referred to as social norms) has a decidedly positive flavor, arguing that many, if not most, of these norms are welfare enhancing. This Article looks at the less-appreciated darker side of social norms. It combines an analysis of modern sophisticated tax planning techniques with existing empirical studies of commercial relationships to reveal a disturbing connection. By relying on tacit understandings rather than express contractual terms, many taxpayers shift some of their tax liabilities to those whose opportunity to take advantage of social norms is more limited or nonexistent. The resulting inefficiency and inequity is the social cost of social norms. Reducing this cost, however, turns out to be a challenging task. This Article introduces a tax-focused classification of social norms and singles out the type of norms that are particularly inefficient. Unfortunately, while reducing the use of these norms (or eliminating them altogether) would be welfare enhancing, it is unlikely to succeed in practice. Indiscriminately attacking all norms is administratively easier, but socially costly. This Article proposes a compromise between these two courses of action that is more administrable than the first approach and less costly than the second. It also offers a guide that will assist the government in identifying particularly inefficient norms.

INTRODUCTION

Informal, legally unenforceable rules of behavior commonly referred to as social norms have much to be said in their favor. This Article identifies and explores the less-appreciated darker side of norms. By relying on tacit understandings rather than written agreements,

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businesspeople reduce their tax liabilities. In the process, they impose costs on others and incur costs themselves.

Sometimes, this tax reduction is an incidental side effect of welfare-maximizing behavior. Neighborly interactions among the farmers and ranchers in a remote California county and some of the sophisticated transactions executed in the world's financial centers would have different tax consequences if they were (fully) documented. Yet the reasons why these transactions remain (partly) informal have nothing to do with tax planning. The tax benefits are unintentional. But they are tax benefits nonetheless. And their net effect is that those who belong to environments with strong social norms shift some of their tax burden to the rest of us.

Norms that produce this unintentional tax shifting (I call them "tax relevant") are socially costly, but their cost is likely to be modest. Norms deliberately used as tax avoidance devices are much more inefficient. By analyzing several examples of modern, sophisticated tax planning strategies, this Article demonstrates that aggressive taxpayers have learned to capture the power of social norms. As a result, transactions that exist on paper are different from the real arrangements in crucial, sometimes counterintuitive, respects. Contracts that disclaim confidentiality are really confidential. Agreements that are formally separated in time are actually contemporaneous. Long-term commitments are terminable at will in direct contradiction to the contractual terms. As long as the tax treatment of these arrangements is (largely) based on legally enforceable rights and obligations, taxpayers will rely on norms of this type (I call them "tax driven") even though they would have preferred to commit their understandings to writing. The result is a considerable deadweight loss. This loss, combined with the inefficiency and inequity arising from a higher tax burden borne by those whose opportunity to rely on norms is more limited or nonexistent, is the full tax-related social cost of social norms.

Reducing this cost presents unique challenges. Tax-driven norms are clearly wasteful. Social welfare would be improved if the government could cheaply identify these norms and start treating them as legally binding contractual terms for tax purposes. Success in singling out tax-driven norms is unlikely, however, primarily because proving the intent behind a custom—something the government will need to do to convince a court that a norm is indeed tax driven—is extremely difficult.

The seemingly obvious alternative solution—treating all norms as legally binding—will also be costly, even if this treatment is limited to the norms that accompany written contracts (I refer to these as "contractual norms"). Contractual norms are widespread, many are welfare enhancing, and quite a few have no tax consequences at all. Yet every one of these norms will be negatively affected if the government

starts treating all contractual norms as enforceable contractual clauses. This indiscriminate attack will introduce significant uncertainty. It will also force taxpayers to incur large risk-bearing losses or to alter socially beneficial behavior, reducing (sometimes to zero) the expected value of many contractual relationships.

The solution proposed in this Article is a compromise that is more administrable than the first approach and less costly than the second. I suggest that the government treat contractual norms as legally binding for tax purposes only if they produce large tax benefits, exist among sophisticated taxpayers, reveal inefficient allocations of reputational capital, and have several other features discussed in detail below.[1] By focusing on these factors, the government is likely to end up attacking tax-driven norms without making explicit inquiries into the intent behind an informal custom.

This Article contributes both to the tax policy literature and to social norms scholarship. While tax avoidance has been studied in great detail, tax commentators have not focused on the unique features of norm-based tax planning and the challenges of responding to it.[2] More broadly, the tax policy and tax enforcement literature has failed to recognize that social norms are inextricably linked to, and have a profound effect on, the tax burdens of many U.S. taxpayers. This Article is the first effort to identify this link and explore its consequences.

Social norms scholars have long argued that informal practices developed by particular groups may be costly for society as a whole.[3] Concrete examples of such socially harmful norms have been exceedingly rare, however, at least as long as the inquiry was limited to contemporary commercial behavior. This Article's study of tax-relevant and, in particular, tax-driven norms provides a powerful example of modern, ubiquitous, and socially costly social norms.

Part I of this Article frames the inquiry. Part II presents a detailed study of contractual norms and classifies their tax effects. Part III highlights the tax law's uncertain treatment of contractual norms. Part IV identifies the tax-related social cost of contractual norms. Part V considers several approaches to reducing this cost, and offers a novel solution. Part VI explains why the government's response should be limited to contractual norms.

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1 See Part V.D.

2 See text accompanying notes 36–38.

3 See text accompanying notes 206–12.

I. THE (MISSING) TAX ANALYSIS OF SOCIAL NORMS

A. Shasta County and Tax Shelters: Similar or Different?

Order, as Robert Ellickson reminded us over a decade ago, can and does exist without law.[4] Ellickson's meticulous study of everyday life in rural Shasta County reveals that its farmers and ranchers build their relationships not by reference to their legal rights and obligations, but by relying on longstanding and pervasive norms of neighborliness. Neighbors help neighbors build, inspect, and repair fences, retrieve stray cattle, maintain the water supply, execute controlled burns, staff volunteer fire departments, and so on.[5] They do not ask each other for payments,[6] they do not enter into contracts,[7] and they reject out of hand the idea of calling lawyers every time they do not like something their neighbors have done.[8] Shasta County's system of social control is built on shared understandings that are always unwritten, almost always unstated, and frequently unsupported by (or even contrary to) the relevant legal rules.

Shasta County is anything but unique. Researchers studying everyday commercial interactions have found similar informal practices everywhere they looked: among grain and feed merchants,[9] cotton traders,[10] diamond dealers,[11] garment workers,[12] lobster fishermen,[13] beekeepers and orchard growers,[14] shippers and rail carriers,[15] and

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4 See generally Robert C. Ellickson, *Order without Law: How Neighbors Settle Disputes* (Harvard 1991).

5 Id at 54–55.

6 Id at 60–61 (noting that neighbors are "strongly disinclined to submit informal monetary claims to the owners of trespassing animals").

7 Id at 69, 76–77.

8 Id at 60–64. See also id at 52 ("[T]respass conflicts are resolved not *in* 'the shadow of the law' but, rather, *beyond* that shadow.").

9 See Lisa Bernstein, *Merchant Law in a Merchant Court: Rethinking the Code's Search for Immanent Business Norms*, 144 U Pa L Rev 1765, 1787–96 (1996).

10 See Lisa Bernstein, *Private Commercial Law in the Cotton Industry: Creating Cooperation through Rules, Norms, and Institutions*, 99 Mich L Rev 1724, 1745–54 (2001).

11 See Barak Richman, *How Community Institutions Create Economic Advantage: Jewish Diamond Merchants in New York*, 31 L & Soc Inquiry 383, 393–400 (2006); Lisa Bernstein, *Opting Out of the Legal System: Extralegal Contractual Relations in the Diamond Industry*, 21 J Legal Stud 115, 121–30 (1992).

12 See Sally Falk Moore, *Law and Social Change: The Semi-Autonomous Social Field as an Appropriate Subject of Study*, 7 L & Socy Rev 719, 723–29 (1973).

13 See James M. Acheson, *The Maine Lobster Market: Between Market and Hierarchy*, 1 J L, Econ, & Org 385, 396–98 (1985).

14 See Steven N.S. Cheung, *The Fable of the Bees: An Economic Investigation*, 16 J L & Econ 11, 29–30 (1973).

15 See Thomas M. Palay, *Avoiding Regulatory Constraints: Contracting Safeguards and the Role of Informal Agreements*, 1 J L, Econ, & Org 155, 164–69 (1985).

many others.[16] Virtually every scholar who has taken the time to ask businesspeople how they actually conduct their business has reported that the informal arrangements were at least as important as the formal ones. Businesspeople hire lawyers, enter into elaborate contracts, and then avoid calling their lawyers at all costs, and (largely) ignore their contractual rights and obligations. Sometimes, entrepreneurs sign agreements that they (and even their lawyers!) know to be unenforceable.[17] They strongly prefer to do business on a handshake and to resolve disputes "simply by horse-trading over the phone."[18]

All of these informal arrangements fall under the somewhat overused, extremely broad, and fairly ambiguous rubric of social norms.[19] Social norms scholarship is vast and its prevailing attitude toward its object of study is mostly favorable.[20] Scholars argue that

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16 For examples of studies involving other business communities, see Russell J. Weintraub, *A Survey of Contract Practice and Policy*, 1992 Wis L Rev 1, 18–24 (a diverse sample of U.S. companies); James A. Wilson, *Adaptation to Uncertainty and Small Numbers Exchange: The New England Fresh Fish Market*, 11 Bell J Econ 491, 491–92, 496–98 (1980) (freshwater fishermen); Hugh Beale and Tony Dugdale, *Contracts between Businessmen: Planning and the Use of Contractual Remedies*, 2 Brit J L & Socy 45, 48–59 (1975) (Bristol engineering firms); Stewart Macaulay, *Non-Contractual Relations in Business: A Preliminary Study*, 28 Am Sociological Rev 55, 56–62 (1963) (Wisconsin businessmen); Comment, *The Statute of Frauds and the Business Community: A Re-Appraisal in Light of Prevailing Practices*, 66 Yale L J 1038, 1051–62 (1957) (Connecticut manufacturers).

17 See Palay, 1 J L, Econ, & Org at 170 (cited in note 15); Beale and Dugdale, 2 Brit J L & Socy at 49–51 (cited in note 16); Macaulay, 28 Am Sociological Rev at 60 (cited in note 16). Indeed, the lack of legally enforceable remedies may be the contracting parties' deliberate choice. See Robert E. Scott, *A Theory of Self-Enforcing Indefinite Agreements*, 103 Colum L Rev 1641, 1676–80 (2003) (arguing that, in some cases, indefinite agreements may be the most efficient method of contracting, even between strangers involved in one-shot deals).

18 Beale and Dugdale, 2 Brit J L & Socy at 59 (cited in note 16). This preference for informal arrangements existed in the 1950s and 60s, see Macaulay, 28 Am Sociological Rev at 61 (cited in note 16); Comment, 66 Yale L J at 1051–62 (cited in note 16), and it remained true in the 90s, see Bernstein, 144 U Pa L Rev at 1788 (cited in note 9); Weintraub, 1992 Wis L Rev at 18–24 (cited in note 16). The aversion to formality is so strong that American cotton merchants created an entire private dispute resolution system to avoid taking their disputes to state and federal courts, and then developed informal norms against settling their disagreements by resort to this private yet formal system. See Bernstein, 99 Mich L Rev at 1754 (cited in note 10).

19 One of many social norm definitions is "informal social regularities that individuals feel obligated to follow because of an internalized sense of duty, because of a fear of external non-legal sanctions, or both." Richard H. McAdams, *The Origin, Development, and Regulation of Norms*, 96 Mich L Rev 338, 340 (1997). Many other definitions have been offered. See Marcel Kahan, *The Limited Significance of Norms for Corporate Governance*, 149 U Pa L Rev 1869, 1870–71 (2001). In fact, the concept of social norms is so broad that Cass Sunstein's decade-old warning may well have come to pass. Social norms have indeed "become a conclusory response to any apparently anomalous results." Cass R. Sunstein, *Social Norms and Social Roles*, 96 Colum L Rev 903, 945 (1996).

20 Several symposia have been held on the subject. See Symposium, *Norms and Corporate Law*, 149 U Pa L Rev 1607 (2001); Symposium, *The Legal Construction of Norms*, 86 Va L Rev 1577 (2000); Symposium, *Social Norms, Social Meaning, and the Economic Analysis of Law*, 27 J Legal Stud 537 (1998); Symposium, *Law, Economics, and Norms*, 144 U Pa L Rev 1643 (1996).

social norms reduce transaction costs,[21] facilitate long-term cooperation,[22] solve strategic dilemmas,[23] spur innovation,[24] help to resolve unique contracting problems,[25] assure fuller contractual performance,[26] provide for more efficient remedies,[27] underlie socially valuable organizational networks,[28] and reduce the burden on public institutions.[29] For some or all of these reasons, the argument continues, social norms are more efficient than legally binding written contracts,[30] perhaps even

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21 See, for example, Richman, 31 L & Soc Inquiry at 384 (cited in note 11) (arguing that the Jewish diamond traders' informal exchange system is "less costly, more reliable, and thus superior" to a legal regime); Bernstein, 99 Mich L Rev at 1760 (cited in note 10); Bernstein, 144 U Pa L Rev at 1789 (cited in note 9) ("Sometimes transactors allocate aspects of their contracting relationship to the extralegal realm because the transaction costs of including a sufficiently well-specified written provision in their contract would exceed the benefits.").

22 See, for example, Bernstein, 144 U Pa L Rev at 1771, 1787–90 (cited in note 9).

23 See, for example, Robert H. Frank and Philip J. Cook, *The Winner-Take-All Society: Why the Few at the Top Get So Much More Than the Rest of Us* 172–77 (Penguin 1995) (arguing that social norms prevent competing groups from engaging in excessive, mutually offsetting levels of effort). But see Eric A. Posner, *Law and Social Norms* 171–72 (Harvard 2000) (raising several difficulties with the claim that "social norms solve strategic dilemmas that would otherwise reduce overall well-being").

24 See, for example, Bernstein, 144 U Pa L Rev at 1814 (cited in note 9).

25 See, for example, Richman, 31 L & Soc Inquiry at 389 (cited in note 11) (claiming that legal remedies are powerless to prevent theft of diamonds); Bernstein, 99 Mich L Rev at 1745 (cited in note 10) (noting that because cotton quality is difficult to value, deviations from the agreed-upon quality are hard to prove in court); Bernstein, 21 J Legal Stud at 136, 141 (cited in note 11) (finding that because delays in obtaining judgment would ruin a diamond trader who is typically short on cash, and because Jewish law prohibits Jews—the primary diamond exchange participants—from suing each other in court, legal remedies are unavailable and would be inadequate).

26 See, for example, Bernstein, 99 Mich L Rev at 1761 (cited in note 10) (contending that norm-based enforcement facilitates the performance of "interior contractual provisions," that is, those whose performance is not worth litigating).

27 See, for example, id at 1758–59 ("[T]he system of [nonlegal] sanctions as a whole may discourage inefficient breach, and, because renegotiation is not uncommon, the loss from inefficient over-performance is unlikely to be large."); Bernstein, 21 J Legal Stud at 135 (cited in note 11) (positing that contractual norms avoid "inefficiently high levels of breach" by facilitating extralegal remedies).

28 See, for example, Simon Deakin, Christel Lane, and Frank Wilkinson, *"Trust" or Law? Towards an Integrated Theory of Contractual Relations between Firms*, 21 J L & Socy 329, 342 (1994) ("Social norms which set boundaries to the extent and form of competition within the industrial district may ... operate to enhance the operational and dynamic efficiency of the productive system as a whole.").

29 See, for example, Bernstein, 99 Mich L Rev at 1788–90 n 237 (cited in note 10).

30 See Richman, 31 L & Soc Inquiry at 409 (cited in note 11) ("[T]rade networks organized around families and friends can execute informal contracts that enjoy efficiencies unavailable to formal, arm's length transactions."); Bernstein, 99 Mich L Rev at 1788–90 n 237 (cited in note 10) (claiming that extralegal dispute resolution "promote[s] transactional efficiency without creating barriers to entry").

Pareto superior.[31] Ellickson's own hypothesis, after all, was that of "welfare-maximizing norms."[32]

While the role of social norms in contract law,[33] corporate law,[34] and labor law,[35] among others, has received considerable attention, scholarship concerned with their tax effects has been modest at best. Economic theory's inability to explain the "abnormally" low level of tax evasion has led several scholars to suggest that there is a general norm of tax compliance in the United States.[36] In contrast, Linda Beale has argued that the tax bar shares the norm supporting highly aggressive interpretations of the tax law.[37] Steven Bank and Michael Kirsch have each considered how particular tax rules may affect some norms of corporate behavior, patriotism, and individual autonomy, and both have concluded that a significant impact is unlikely.[38] All these argu-

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31 Bernstein, 21 J Legal Stud at 117 (cited in note 11) (arguing that any regime of extralegal norms "must be Pareto superior to the established legal regime in order to survive").

32 Ellickson, *Order without Law* at 169 (cited in note 4).

33 See generally, for example, Robert E. Scott, *The Case for Formalism in Relational Contract*, 94 Nw U L Rev 847 (2000); Bernstein, 144 U Pa L Rev 1765 (cited in note 9); David Charny, *Illusions of a Spontaneous Order: "Norms" in Contractual Relationships*, 144 U Pa L Rev 1841 (1996).

34 See generally, for example, Symposium, 149 U Pa L Rev 1607 (cited in note 20).

35 See generally, for example, Edward B. Rock and Michael L. Wachter, *The Enforceability of Norms and the Employment Relationship*, 144 U Pa L Rev 1913 (1996); Walter Kamiat, Comment, *Labor and Lemons: Efficient Norms in the Internal Labor Market and the Possible Failures of Individual Contracting*, 144 U Pa L Rev 1953 (1996).

36 For a discussion of this norm by nontax scholars, see, for example, Dan M. Kahan, *Trust, Collective Action, and Law*, 81 BU L Rev 333, 340–44 (2001); Eric A. Posner, *Law and Social Norms: The Case of Tax Compliance*, 86 Va L Rev 1781, 1805–08 (2000); Robert D. Cooter, *Three Effects of Social Norms on Law: Expression, Deterrence, and Internalization*, 79 Or L Rev 1, 4 (2000). Tax academics and public finance economists have also considered the tax compliance norm, and have even attempted to incorporate it in formal models. See, for example, Leandra Lederman, *The Interplay between Norms and Enforcement in Tax Compliance*, 64 Ohio St L J 1453, 1459–63 (2003); James Andreoni, Brian Erard, and Johnathan Feinstein, *Tax Compliance*, 36 J Econ Lit 818, 850–52 (1998) (reviewing studies on how moral values, perceptions of fairness, and attitudes toward government affect tax compliance and concluding that successfully incorporating these concepts into a model will be difficult).

37 Linda M. Beale, *Tax Advice before the Return: The Case for Raising Standards and Denying Evidentiary Privileges*, 25 Va Tax Rev 583, 596–607 (2006).

38 Bank suggests that certain tax provisions may be viewed as congressional attempts to influence the norms of corporate behavior related to cash retention policies and corporate reorganizations. He concludes that the tax law is unlikely to succeed when it aims at changing these norms, but may be effective in reinforcing them. See Steven A. Bank, *Tax, Corporate Governance, and Norms*, 61 Wash & Lee L Rev 1159, 1228–32 (2004). Kirsch considers two recent provisions aimed at taxpayers who attempt to reduce their United States tax liabilities by expatriating. The new laws shame these individuals and prohibit their reentry into the U.S. Kirsch concludes that neither provision is likely to have a significant effect on the existing norms of patriotism, individual autonomy, and freedom of migration, or serve as an effective impediment to tax-motivated expatriations. See Michael S. Kirsch, *Alternative Sanctions and the Federal Tax Law: Symbols, Shaming, and Social Norm Management as a Substitute for Effective Tax Policy*, 89 Iowa L Rev 863, 916–21 (2004).

ments have focused on the interplay between tax legislation or tax enforcement on the one hand and a single norm or a few specific norms on the other. Neither the tax scholars nor the norms scholars have suggested that social norms in general are inextricably linked to, and have a profound effect on, the tax burdens and tax planning of many U.S. taxpayers.

Yet what if, to take Shasta County as a classic example, we considered some of the interactions described by Ellickson with an eye toward tax law? It would quickly become apparent that Shasta County inhabitants routinely engage in all sorts of commercial transactions that, if formalized, would produce tax consequences for one or both parties. Neighbors borrow ("rent," in tax speak) each other's equipment.[39] They help each other with chores such as fence building and maintenance; that is, they provide services to each other. Occasionally, one neighbor supplies the other with building materials for a joint project.[40] For tax purposes, this transfer may be characterized as a sale, depending on the circumstances.

Even this cursory analysis suggests that in the world of neighbors helping neighbors, one thing they may help each other do is reduce their tax liabilities. Rental and services income, if actually paid to lessors and service providers, would be clearly taxable to them.[41] The amount realized from a sale of property is also taken into account in computing taxable income.[42] While there may be an offsetting deduction for the lessees and service recipients, it will not always be available immediately, or even at all. For instance, the fence building costs must be capitalized and deducted over time.[43] An owner of a small "ranchette" which is not a trade or business may lose the entire deduction if it does not exceed 2 percent of her adjusted gross income.[44] Thus, if a farmer rents a bulldozer from a rancher who does not charge the farmer a $500 rental, and in return the farmer helps the rancher to build or repair a fence sometime later and does not charge a $500 fee for this service, the tax system may lose up to $1,000 of taxable income.

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39 Ellickson, *Order without Law* at 80 (cited in note 4) (observing that when a neighbor failed to shoulder an equitable share of fencing costs and ignored a request to lend his bulldozer, one Shasta County rancher "got even" by "borrowing" the bulldozer without permission).

40 Id at 74.

41 Internal Revenue Code, 26 USC § 61 (2006).

42 26 USC § 1001 (2006).

43 26 USC §§ 167–68, 263 (2006).

44 26 USC § 67 (2006) (establishing a 2 percent floor for miscellaneous itemized deductions). See also Ellickson, *Order without Law* at 21 (cited in note 4) (describing ranchette owners' limited activities that are unlikely to constitute a trade or business for tax purposes).

Nothing in Ellickson's story suggests that Shasta County's dominant social norm of "live and let live"[45] has any connection to tax planning. Most likely, a suggestion that their neighborly habits exist to lower their tax bills would outrage the County old-timers. If the same is true of all social norms—if the biggest concern is that some informal understandings occasionally give a few cooperative taxpayers a modest tax cut—the situation is not exactly dire. Unfortunately, the Shasta County norms are not the biggest problem.

Developing and selling highly aggressive tax reduction strategies (tax shelters) is a lucrative business.[46] It is also very secretive.[47] Flagrant tax cheating is easy. Sophisticated tax avoidance techniques that have a reasonable chance to be sustained in court are much more difficult to invent.[48] Because tax shelter clients are interested in strategies of the latter type, and because they are willing to pay handsomely for them, secrecy is paramount. A tax shelter promoter who develops a new scheme that is likely to work can earn large fees, but only as long as the promoter has a monopoly on this strategy. Once competitors learn about it and start selling a similar product, the profit will quickly dissipate.

For years, promoters insisted that their prospective clients sign confidentiality agreements, often before learning anything about the products the promoter had to offer.[49] These agreements were needed not to keep the new tax shelter ideas from the IRS—the clients' incentives to keep the IRS in the dark were as strong as those of the promoters—but to stave off the competition. However, when the government decided to mount a serious attack on the tax shelter industry, it seized on the confidentiality provision as a reliable trait of a suspicious scheme. The tax shelter regulations finalized in 2003 list several features of transactions viewed by the government as tax avoidance and require taxpayers to disclose all transactions that contain any of these features.[50] Confidentiality is one of the features on that list.[51]

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45 Ellickson, *Order without Law* at 54–55 (cited in note 4).

46 For instance, KPMG received $128 million in fees for selling four tax shelters between 1996 and 2002. Sheryl Stratton, *Tax Professionals Indicted; KPMG Says Shelters Were Fraudulent*, 108 Tax Notes 1085, 1087 (2005).

47 See John Braithwaite, *Markets in Vice, Markets in Virtue* 109 (Oxford 2005) (explaining that the promoters' "strategy is to keep their new shelter as tightly held a secret as possible").

48 Id at 106 (quoting a corporate tax director's opinion that "[i]t's only a small group of people creative and talented enough to generate new product ideas").

49 See Joseph Bankman, *The New Market in Corporate Tax Shelters*, 83 Tax Notes 1775, 1789 (1999).

50 See Internal Revenue Service, Tax Shelter Regulations, 68 Fed Reg 10161 (2003), to be codified at 26 CFR Parts 1, 20, 25, 31, 53, 54, 56, 301, and 602 (withdrawing several sets of proposed regulations and promulgating final regulations under 26 USC §§ 6011(a), 6111(d), and 6112 (2006)).

51 See Treas Reg § 1.6011-4(a)(3).

It should surprise no one to learn that when these regulations came out, confidentiality agreements disappeared overnight. Instead, tax shelter (as well as many non–tax shelter) documents now have express confidentiality disclaimers, unequivocally allowing clients to broadcast the latest tax planning strategies (or, at least, their "tax treatment and tax structure") to the entire world.[52] What may be more surprising is that this dramatic shift in legal obligations changed little in how the tax shelter business is actually conducted. Many practitioners believe that an informal norm replaced a formal obligation.[53] In the past, disclosure could lead to legal sanctions. Today, shelter customers know that if they disclose a new tax avoidance strategy to anyone (especially the promoter's competitors), they may not see another tax planning idea from this promoter, or from most others, for some time.[54]

Of course, this "confidentiality norm" is not bulletproof. Sooner or later, all new tax shelter ideas become widely known.[55] But the same was true in the era of legally enforceable confidentiality clauses.[56] Thus, however effective was a threat of legal sanctions, a shared un-

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52 These disclaimers were encouraged by a regulatory presumption. Explaining the meaning of the "conditions of confidentiality," the regulations started with a very broad "facts and circumstances" test that took account of limitations on disclosure "in any way by an express or implied understanding or agreement." Treas Reg § 301.6111-2(c)(1). However, the regulations offered an escape hatch:

> Unless facts and circumstances indicate otherwise, an offer is not considered made under conditions of confidentiality if the tax shelter promoter provides express written authorization ... to disclose to any and all persons, without limitation of any kind, the tax treatment and tax structure of the transaction, and all materials of any kind ... that are provided to the [shelter] offeree related to such tax treatment and tax structure.

Treas Reg § 301.6111-2(c)(3). To be sure, the presumption is unavailable if the "facts and circumstances indicate otherwise." Id. Yet, a court will be hard pressed to disregard an express clause granting unconditional permission to disclose in light of an informal, somewhat vague, and not universally shared norm.

53 John Braithwaite, who researched the U.S. tax shelter industry, reported a similar finding: "One tax partner said, 'They're still confidential but they don't say they're confidential. There is just no enforceable confidentiality agreement.'" Braithwaite, *Markets in Vice* at 116 (cited in note 47).

54 Some practitioners have a somewhat different view. They believe that there had always existed an informal understanding that clients should not shop around tax-motivated schemes, but this understanding became the main enforcement mechanism upon enactment of the tax shelter disclosure rules. Whatever the explanation, the result is the same: a disappearance of a legally enforceable obligation not to disclose made little difference in practice due to the existence of an informal norm against disclosure.

55 See Braithwaite, *Markets in Vice* at 116 (cited in note 47).

56 See Bankman, 83 Tax Notes at 1789 (cited in note 49) ("[C]onfidentiality agreements are not in the long run successful at keeping shelters secret from one's competitors."). In either case, as long as the idea's developer can capture the first-mover advantage, confidentiality remains important to the tax shelter market. See, for example, Braithwaite, *Markets in Vice* at 116 (cited in note 47) ("Idea developers can be strenuous in attempting to protect their idea—even on occasion patenting the structure of a transaction—but it is only a matter of keeping a finger in the dyke to maintain a first mover advantage for as long as possible.").

derstanding among tax shelter promoters and clients works (nearly) as well. As a result, those wealthy enough to be tax shelter customers reduce their effective tax rates.

The neighborly customs of Shasta County and the tax shelter confidentiality norm clearly differ in many important respects. However, they also have much in common. Both reflect tacit understandings among a particular group of taxpayers. Both rely on informal enforcement mechanisms. And both reduce the tax burden on those who take advantage of the cooperation made possible by social norms. Whether Shasta County and tax shelters are similar or different—at least for tax policy purposes—is not entirely clear.

B. Framing the Inquiry

These observations raise more questions than they answer. Do the Shasta County conventions and the confidentiality norm represent isolated incidents or a widespread phenomenon? Should the differences between these norms outweigh their similarities as far as the tax law and tax administration are concerned? How should the government deal with these types of informal practices, if at all?

Academic literature has little to say in response. Maybe tax scholars have underestimated the extent to which customary practices are embedded in commercial dealings of all kinds—something their nontax colleagues learned to appreciate decades ago. Perhaps the problem seemed peripheral, or the solution appeared obvious or unreachable. Or it may be that the tax analysis of social norms has been viewed as merely part of a broader inquiry into how the tax law should take account of informal arrangements.[57] Whatever the reason, the doctrinal treatment of customary practices remains unclear,[58] and their conceptual analysis is all but nonexistent. Yet customary arrangements are a crucial component of modern business relationships.

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[57] That inquiry, however, has been extremely limited. While informal arrangements are no doubt omnipresent, tax scholars have made little effort to consider how they should be treated for tax purposes. The few commentators who have tried to make sense of extrastatutory doctrines that could conceivably be used to reach implicit arrangements have essentially ignored the issue. See, for example, Saul Levmore, *Recharacterizations and the Nature of Theory in Corporate Tax Law*, 136 U Pa L Rev 1019, 1059–65 (1988) (recognizing legal uncertainty surrounding the government's ability to recast taxpayers' transactions, and offering solutions that do not address informal arrangements); Joshua D. Rosenberg, *Tax Avoidance and Income Measurement*, 87 Mich L Rev 365, 402–03 (1988) (mentioning in passing the tax law's difficulty in accounting for informal enforcement mechanisms). Similarly, a careful study of opinions written by Learned Hand—perhaps the most important single contributor to the development of the substance-over-form, business purpose, and economic substance doctrines—does not reveal any insights into tax treatment of tacit understandings. See generally Marvin A. Chirelstein, *Learned Hand's Contribution to the Law of Tax Avoidance*, 77 Yale L J 440 (1967).

[58] See Part III.

Their tax effects are often subtle and complicated. Moreover, social norms present unique conceptual, doctrinal, and enforcement problems that deserve independent consideration.[59]

To organize the analysis of the tax policy and tax enforcement issues raised by the Shasta County and tax shelter examples, this Article will proceed from the specific to the general. We can narrow the inquiry into the limitless universe of social norms by observing three salient features of both informal practices considered thus far. First, they are used in commercial relationships (unlike, for example, a norm against flag burning or smoking in public places). Second, they do not arise from explicit negotiations that clearly and deliberately violate the law (like the bargaining that takes place when a cartel is established or, one would think, when a new member joins a Mafia "family"). Finally, both norms are enforced primarily by decentralized external sanctions such as withdrawal of cooperation and expulsion from the group that follows these norms (rather than internal sanctions such as guilt and shame, or centralized sanctions such as those imposed by trade associations and professional organizations). Social norms that have all three of these features, which I will call "commercial norms," are the only ones considered in this Article.[60]

In fact, most of the following discussion will be even more narrowly focused. Conceptual, doctrinal, and pragmatic considerations discussed below suggest that one difference between the confidentiality convention and the neighborliness norm is particularly relevant in the tax policy analysis. The former accompanies express, formal, legally enforceable contracts. The latter operates in the environment where few binding agreements exist. The former is an example of what I refer to as a "contractual norm," while the latter is not. Thus, a contractual norm is a commercial norm that operates in connection with, and usually modifies, an enforceable written contract.[61]

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[59] In fact, I will argue that the current law's one-size-fits-all approach is ill suited not only for all informal agreements, but even for all *multilateral* informal arrangements, that is, social norms. See Part VI.

[60] The inquiry is not limited, however, to the environments where commercial norms supply the *exclusive* enforcement mechanism.

[61] Contractual norms are studied by both social norms scholars and those interested in self-enforcing relational contracts, but neither literature has embraced the term "contractual norm." But see Peter H. Huang and Ho-Mou Wu, *More Order without More Law: A Theory of Social Norms and Organizational Cultures*, 10 J L, Econ, & Org 390, 391 (1997) (using the term "contractual norm" in passing); Robert E. Scott, *Conflict and Cooperation in Long-Term Contracts*, 75 Cal L Rev 2005, 2009 (1987) (same). The two areas of inquiry have a somewhat different scope and focus. For both reasons, the social norms framework provides a better fit for my analysis. First, although both the self-enforcing contracts literature and the social norms literature are interested in how informal sanctions affect their followers, see Posner, *Law and Social Norms* at 68–78, 89–94, 133–40, 148–61 (cited in note 23); Benjamin Klein, *Why Hold-Ups Occur:*

It makes sense to begin the analysis with the relatively narrow category of contractual norms for two reasons. First, it is challenging enough to understand and analyze the tax implications of informal arrangements even if we focus exclusively on contractual norms. Second, if responding to tax planning based on contractual norms proves to be difficult, we may think twice before attempting to address the broader category of commercial norms. Thus, our inquiry into the cost of norms begins with contractual norms.[62]

II. THE TAX-FOCUSED CLASSIFICATION OF CONTRACTUAL NORMS

Despite decades of scholarly interest in social norms, we know virtually nothing about whether (and how) contractual norms are used in modern tax planning. Nor has anyone considered systematically the tax implications of contemporary and well-known contractual norms. This Part begins to remedy both problems.

A. Tax-Driven Norms

When an unstated convention replaced formal agreements as the primary mechanism of enforcing tax shelter confidentiality, few informed observers had doubts regarding the reasons for the change. The confidentiality norm did not exist as long as parties could use contractual confidentiality provisions (or, if it did exist, it played a secondary role), and it emerged as soon as tax shelter regulations made these provisions self-defeating. The unstated norm that an offeree of a tax shelter shall not disclose it to anyone (other than her lawyers) developed in response to a change in the tax law and as an attempt to circumvent that change. The norm of confidentiality in the tax shelter setting is an example of what I refer to as a "tax-driven" norm—an informal customary practice adopted (or persisting) in order to obtain a tax benefit by foregoing formalization of a particular understanding.

The Self-Enforcing Range of Contractual Relationships, 34 Econ Inquiry 444, 449 (1996); Scott, 75 Cal L Rev at 2039–42, only the social norms literature is also concerned with the broader societal implications of norms, see text accompanying notes 206–15. This Article's goal is to study one (tax-related) aspect of such broader effects. Second, contract law scholars focus on private law, while social norms scholars look principally to public law. For tax policy analysis, a public law orientation is more helpful. Compare Klein, 34 Econ Inquiry at 462; Scott, 75 Cal L Rev at 2050–51, with Robert C. Ellickson, *Law and Economics Discovers Social Norms*, 27 J Leg Stud 537, 548 (1998) (identifying the "New Chicago School" in part by its tendency to "favor governmental activism in the molding of norms"). Nonetheless, the self-enforcing contracts scholarship contains many valuable examples of contractual norms and unique insights into their operation. See Part V.D.7.

62 The analysis of commercial norms that accompany explicit cash-based exchanges is similar in many respects to that applicable to contractual norms. I do not discuss these noncontractual norms separately to avoid turning this Article into a treatise.

A recent controversy provides another example of a contractual norm used as a potent tax planning device. The dispute involves a hedging technique popular in the late 1990s and early 2000s. The dot-com boom and the rise of stock option executive compensation left numerous taxpayers with significant, undiversified, and highly appreciated stock portfolios. Many wanted to hedge and monetize their positions without, of course, paying tax on their gains.[63] Financial institutions responded by developing a hedging strategy called a variable delivery prepaid forward (VPF). Pursuant to the terms of a typical VPF, a taxpayer who wanted to effectively sell one hundred shares would promise to deliver from eighty to one hundred shares or their value in cash to the financial institution several years later, while receiving a fixed price at the inception of the forward.[64] In 2003, the IRS concluded in a revenue ruling that a VPF was neither a sale under general tax principles nor a constructive sale under § 1259.[65] The strategy worked.

Apparently, the IRS did not realize (despite being warned by David Schizer as early as 2001[66]) that banks could put clients' appreciated shares to a very good use while the VPF remained outstanding. Entering into the long side of a forward contract gave the banks unwanted exposure to the underlying stock. They routinely hedged that exposure by selling some of the same shares short, that is, by borrowing them and selling them onto the market. Because VPFs involved significant positions, the banks needed to find and borrow large blocks of shares. The shares pledged by clients to secure their obligations under VPFs provided a perfect source of stock.[67]

While borrowing the pledged shares raised no issues under the constructive sale rules of § 1259, another part of the Internal Revenue Code presented a problem. Section 1058 provides that a securities

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63 For a detailed discussion of hedging strategies, see David M. Schizer, *Frictions as a Constraint on Tax Planning*, 101 Colum L Rev 1312, 1340–45 (2001).

64 For a detailed description of a VPF, see Alex Raskolnikov, *Contextual Analysis of Tax Ownership*, 85 BU L Rev 431, 441–44 (2005).

65 See Rev Rul 2003-7, 2003-1 Cum Bull 363, 364, 365.

66 See Schizer, 101 Colum L Rev at 1355 (cited in note 63).

67 The banks needed to make sure that if the shares appreciated significantly between the inception of the forward and its settlement date, that is, if the VPF turned out to be a bad deal for their client, the client would perform and deliver the shares for what would then be a below-market price. To protect themselves from the risk of default, the banks invariably required clients to pledge the maximum number of shares deliverable under the VPF. The 2003 ruling concluded that the pledge of the shares did not turn a VPF into a sale, at least as long as the shares were held by an independent trustee. See Rev Rul 2003-7, 2003-1 Cum Bull 363, 364. If the stock underlying the VPF was liquid, the banks could borrow it elsewhere. However, it was cheaper to borrow the client's shares, and the cost savings were usually reflected in the pricing of the forward. If the stock was illiquid, or if the position was very large, the client's shares were the only realistic source of the stock needed to establish the bank's short position.

loan is not a taxable transaction as long as, among other things, the loan is not a part of an agreement that reduces the lender's risk of loss or opportunity for gain from the transferred securities.[68] A stock loan, that is, cannot be tied to a VPF on the same stock. If, in the words of § 1058, they are a part of the same "agreement," the nonrecognition regime does not apply and the whole purpose of the transaction is utterly defeated: the clients must pay tax on the entire gain immediately.

The question that has perplexed many of the brightest tax minds on Wall Street for some time is when exactly do two transactions—the VPF and the share lending—become a single agreement for tax purposes? Many practitioners believe that the term "agreement" is broader than "contract," but how much broader? To exaggerate only somewhat, the most aggressive (or the least well-advised) taxpayers took a view that as long as the two contracts were written on separate pieces of paper, they represented different agreements. These taxpayers entered into the VPF and the share lending agreement simultaneously, and the two contracts were expressly and closely interrelated.[69]

But the more conservative advisers searched for ways to disentangle the two contracts. At least one solution was to separate the VPF and the stock lending agreement in time. Gradually, a market practice developed. The parties negotiated and entered into the forward with an understanding that sometime in the future (usually between thirty and ninety days) the bank would ask for the taxpayer's permission to borrow the pledged shares.[70] Perhaps the parties even discussed this future request. However, no doubt at the tax lawyers' insistence, no concrete promises were exchanged, no express references to such future share lending were made in the VPF documents, and the client was under no legally binding obligation to enter into a share lending agreement when the VPF was consummated. Sometimes the forward contract would provide that the bank could terminate the VPF if it could no longer hedge on "reasonable terms,"[71] or if its hedging costs

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68 26 USC § 1058(a), (b)(3) (2006).

69 Three years after issuing the revenue ruling blessing VPFs, the IRS has audited one of these aggressive taxpayers, has awakened to the reality of stock lending, and has opined in a technical advice memorandum that taxpayers in these circumstances cannot defer their built-in gain by relying on a nonrecognition regime of § 1058. See Technical Advice Memorandum 200604033 at 3 (Jan 27, 2006), online at http://www.irs.gov/pub/irs-wd/0604033.pdf (visited Apr 17, 2007). In addition, the IRS has concluded that when a VPF seller lends the stock to the counterparty, the entire transaction should be viewed as a taxable sale under general tax principles. See id. See also Lee A. Sheppard, *Should Share Lending Affect a Prepaid Forward Contract?*, 110 Tax Notes 12, 13–15 (2006).

70 See Sheppard, 110 Tax Notes at 17; Schizer, 101 Colum L Rev at 1355 (cited in note 63).

71 See Technical Advice Memorandum 200604033 at 20 (cited in note 69).

increased materially, or upon some other vaguely defined significant adverse change related to the bank's hedge. However, no legally enforceable obligation to lend appeared anywhere.

How could the banks take on a risk of not being able to borrow the clients' shares? They relied on a contractual norm rather than contractual language. Even though clients had no legally binding obligation to lend, the expectation was that they would cooperate and lend the shares. Banks knew this, many clients knew this, and those clients who did not were quickly educated by their bankers, their tax lawyers, or even other clients. Just as with the confidentiality norm, the market practice of delayed share lending (the "VPF stock lending norm") emerged so that the parties could avoid incorporating the agreement to lend into explicit contractual language. In both cases, the choice was motivated by tax considerations. Both norms were tax driven.

Everything old is new again. About a decade after the stock market bubble led to the proliferation of VPFs and the development of the VPF stock lending norm, hedge funds have come to rely on a similar norm to help their own tax planning. Over the past several years, hedge funds' search for new sources of revenue brought them to the U.S. debt markets.[72] Here they encountered a tax problem.

Many U.S. loans are syndicated.[73] A lead bank assembles a syndicate of other banks, evaluates the borrower's business and financial condition, negotiates the loan documents, and then apportions loan tranches to the syndicate members.[74] Syndication allows the banks to enter into a larger number of relatively small loans, diversifying—and therefore reducing—their overall risk.

Loan tranches can be, and frequently are, sold sometime after the loan is initiated. Just like corporate bonds, these tranches are viewed as "securities" for tax purposes.[75] When foreign corporations (the preferred organizational form of many hedge funds[76]) buy and sell these securities, their activities fall within the "securities trading safe har-

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72 See, for example, Lee A. Sheppard, *News Analysis: Neither a Dealer nor a Lender Be, Part 2: Hedge Fund Lending*, 108 Tax Notes 729, 730 (2005) (describing hedge funds as "aggressively jumping into lending"); Mark H. Leeds, *When the Exotic Embraces the Mundane: The Total Return Swap Business Expands to Bank Loans*, 107 Tax Notes 231, 231 (2005) (characterizing hedge funds as "big players in the bank loan market" and "increasingly active in the bank loan origination process").

73 See Sheppard, 108 Tax Notes at 731 (cited in note 72).

74 See, for example, Lee A. Sheppard, *Is Hedge Fund Lending as Un-American as Warm Beer?*, 111 Tax Notes 770, 770 (2006).

75 See id at 771.

76 See Sheppard, 108 Tax Notes at 730 (cited in note 72) (noting that a typical hedge fund "claims to be nonresident merely by virtue of having been organized as a corporation in a tax and banking haven"); Leeds, 107 Tax Notes at 231–32 (cited in note 72).

bor," and the foreign seller's gains are tax free.[77] However, the tax law views loan initiations not as trading in securities but as conducting a business in the United States.[78] Foreign individuals are fully taxable on profits derived from their U.S. trade or businesses, and foreign corporations pay a double tax. Thus, for hedge funds, the difference between trading in U.S. loans and originating them is a large tax on their profits.[79]

For a variety of reasons, hedge fund managers are very interested in acquiring loan tranches as soon as the loan is made.[80] Doing this, however, brings them close to becoming engaged in a U.S. trade or business. Purchasing loan participations sometime after the origination assures the hedge funds that these tranches will be treated as securities, but is inconsistent with the managers' trading strategies. The business preference runs against the tax cost. Just as with delayed stock lending, a contractual norm comes to the rescue.

More aggressive managers accept the tax risk and acquire loan participations at origination.[81] Others wait, but enter into forward contracts obligating them to purchase tranches from the syndicating banks (or the syndicate member banks) for a fixed price.[82] More conservative managers, however, simply wait to acquire tranches, usually for two days after the loan origination.[83]

But a lot can happen in two days. Lead banks negotiate the loans and lend tens of millions of dollars, relying on the hedge funds to provide the cash. When all terms are agreed on, and all documents are signed, the lead bank is committed to the loan, but the hedge funds (that do not enter into forwards to purchase the tranches) are not. At least, these hedge funds are under no legally binding obligation to acquire the loan tranches.

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77 See 26 USC § 864(b)(2)(A)(ii) (2006). For a detailed explanation, see, for example, Leeds, 107 Tax Notes at 236–37 (cited in note 72).

78 See Sheppard, 108 Tax Notes at 730 (cited in note 72) ("[T]he threshold for being considered to be in the trade or business of lending in the United States is not high, and the rules that hedge funds depend on to avoid U.S. taxation on their other activities will not protect their lending.").

79 See Leeds, 107 Tax Notes at 231–32 (cited in note 72).

80 See Sheppard, 108 Tax Notes at 734 (cited in note 72) (noting that hedge funds typically acquire loans when "the ink is barely dry on the loan documents," within forty-eight hours at the latest). In conversations with the author, several practitioners drew analogies to "hot" IPO stocks that traders often "flip," that is, sell shortly after the IPO, often for a considerable profit.

81 See Sheppard, 111 Tax Notes at 771 (cited in note 74) (citing a practitioner's statement that "loans are often funded by hedge funds on the closing date").

82 See Sheppard, 108 Tax Notes at 732–34 (cited in note 72). Most tax lawyers believe that the contract must have a material adverse effect clause to separate the purchase from the origination. See id.

83 See Sheppard, 111 Tax Notes at 771 (cited in note 74) (citing a practitioner's opinion that "48 hours was enough time to make a hedge fund a purchaser in the secondary market").

At this point, it should come as no surprise that an informal norm has developed among commercial banks and hedge funds: unless something really catastrophic or unexpected happens in the intervening forty-eight hours, the hedge funds will buy, and the lead banks will sell, the loan participations on the same terms they would have accepted at the loan's origination.[84] Assuming the world does not stand still for two days, this will be a slightly (or not-so-slightly) good or bad deal either for the banks or for the hedge funds. Both parties must believe that the norm is sufficiently strong to foreclose opportunistic behavior. It also appears that the only reason for this norm's existence is to keep the hedge funds from being engaged in a U.S. trade or business.[85] Thus, the "loan origination norm" is tax driven.

The final example of a tax-driven norm also involves a cross-border issue. Foreign taxpayers are generally not taxed on gains from sales of U.S. stocks.[86] Dividends paid on these stocks, however, are subject to a withholding tax that may be as high as 30 percent.[87] Fortunately for wealthy foreign investors, they may easily avoid this tax by making synthetic rather than actual investments.

The derivative of choice is an equity swap—a contract that gives the holder of the long position full exposure to the upside and downside of the underlying equity (or basket of equities) as well as, most importantly for our purposes, a right to receive dividend-equivalent payments.[88] Unlike actual dividends, these payments are clearly not subject to the withholding tax.[89] This trick works, however, only as long as the equity swap fits the tax definition of a "notional principal con-

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84 Alternatively, a hedge fund may have a similar understanding with a syndicate member bank that will hold the loan tranche for two days in anticipation of a sale to the hedge fund. In any case, the parties will take into account two days' worth of interest.

85 Apparently, the government is interested in the substance of the two-day waiting period. See Sheppard, 111 Tax Notes at 771 (cited in note 74). While it has taken no action to date, it intends to address the issue. See Crystal Tandon, *New Treasury Guidance Plan Includes Circular 230 Projects*, 112 Tax Notes 625, 625 (2006).

86 See 26 USC § 871(a)(1) (2006). See also Boris I. Bittker and Lawrence Lokken, *Federal Taxation of Income, Estates and Gifts* ¶ 67.2 (Warren, Gorham & Lamont 3d ed 2004).

87 See 26 USC §§ 1441(a), 1442(a) (2006).

88 An equity swap is a total return swap referencing an equity security or a basket of securities. For instance, a total return equity swap on one share of IBM would provide a foreign investor with the entire upside of this stock and expose her to all of its downside. In addition, the investor would pay periodically to the swap counterparty, usually a financial institution, the equivalent of an interest charge on a floating rate loan equal to the market price of one share of IBM. Finally, the financial institution would pay periodically to the investor amounts equal to dividends paid on one share of IBM during the term of the swap. These are the dividend-equivalent payments.

89 See Treas Reg § 1.863-7(b) (determining the source of swap payments by residence of swap counterparty); 26 USC §§ 1441(a), 1442(a) (mandating withholding on U.S.-source payments only).

tract" (NPC). Among other things, an NPC must provide for a series of periodic payments at specified intervals.[90] How many payments a swap must have to qualify as an NPC and how short the intervals can be is not entirely clear.[91]

For those affluent foreign individuals who want to invest in U.S. equities for the long haul, these limitations are of little concern. They enter into long-term equity swaps with numerous periodic payments and eliminate the withholding tax without any threat of an argument from the IRS. Other foreign taxpayers, however, want to trade U.S. equities rather than invest in them. They would like to buy and sell stocks frequently, perhaps several times a week. For them, the requirement that an NPC provide for a series of periodic payments (and, therefore, have a certain term) presents a considerable obstacle. A very short-term (for example, a day-long) swap would satisfy their business objective but would almost certainly not be an NPC eligible for the withholding exemption. A longer-term swap would assure a favorable tax result, but would lock these traders into positions for too long. It appears that no modification of the equity swaps' express terms could resolve this conundrum for foreign traders. Reliance on a contractual norm, however, could well do the trick.

Formally, foreign traders enter into a number of conservative year-long equity swaps on several U.S. stocks that they would like to start with. At the same time, they and the financial institutions on the other side of these swaps are aware that the traders may request early terminations of most swaps. The parties may discuss this while negotiating the swap documents, or they may leave the issue entirely off the table. The banks may not even know whether a particular foreign client happens to be a long-term investor who intends to hold the swaps to maturity or a short-term trader looking to manage her swaps by closing them out early. Either way, when the documents are signed, the traders have no legal right to terminate early, and the banks are under no enforceable obligation to accede to the clients' early termination requests.

However, at least some practitioners believe that if in a day or two the client asks the bank to terminate the swaps with respect to

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90 According to the regulations, a derivative is an NPC if, among other things, it provides for "payments" at specified "intervals." Treas Reg § 1.446-3(c)(1)(i). The plural form of these nouns means that an NPC must include several periodic payments. A statement that a forward contract is not an NPC provides additional support for this conclusion, see Treas Reg § 1.446-3(c)(1)(ii), as does the different treatment of NPCs and so-called bullet swaps. See Internal Revenue Service, Notional Principal Contracts; Contingent Nonperiodic Payments, 69 Fed Reg 8886, 8898 (2004) (proposing regulations to be codified at Treas Reg § 1.1234A-1(a), (c)).

91 A year-long swap that provides for monthly payments clearly fits the description. A month-long swap with weekly payments most likely does. Few advisors would bless NPCs that provide for significantly fewer payments or have much shorter terms.

some of the stocks (and, perhaps, enter into new swaps with respect to other equities), the bank will almost invariably agree to do so. As importantly, the bank will not charge the client any (significant) termination fee.[92] As a result, by relying on the unwritten customary practice, foreign traders can have their cake and eat it too. They enter into formal long-term swaps that (on their face) clearly eliminate withholding on dividend-equivalent payments. At the same time, they retain the flexibility of managing their notional equity portfolios by terminating some of these swaps early and entering into new ones at will. Of course, the banks could charge large termination fees, or refuse to terminate altogether. But why would they? Like all other norms, the tax-driven "early swap termination norm" is backed by sanctions that are no less real or effective than court-appointed damages.

These examples suggest that, far from being an outlier, the confidentiality norm is indicative of a wider problem. Apparently, in addition to the well-known and well-understood techniques such as an (overly) literal interpretation of statutory language,[93] the use of tax-indifferent parties,[94] and the construction of needlessly complex schemes designed to confuse the IRS and the courts,[95] taxpayers have added yet another weapon to their tax planning arsenal. They use contractual norms as tax avoidance devices.

This conclusion may surprise the social norms and relational contracts scholars. The financial transactions just described appear to take place in impersonal, rational markets where atomistic self-interested agents interact at arm's length. These settings are antithetical to close-

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92 Early swap terminations cost banks little (if anything). Being financial intermediaries, banks always hedge their client trades. A total return equity swap on one share of IBM gives a bank a short position in IBM. A bank can hedge this position perfectly by purchasing that share. Although the bank would have to fund the purchase, the client's interest-like payments on the swap would offset the funding cost. Once the bank hedges its position under the swap, it locks in the profit on the trade—the profit realized because the price of the share notionally sold by the bank by entering into the swap is slightly higher than the price of the actual share purchased by the bank as a hedge. From that point on, the bank is (largely) indifferent about the duration of the swap. If a client asks for an early termination, the only thing the bank needs to do is to sell its IBM share used as a hedge and reflect the sale price in the final amount paid or received under the swap.

93 See, for example, Marvin A. Chirelstein and Lawrence A. Zelenak, *Tax Shelters and the Search for a Silver Bullet*, 105 Colum L Rev 1939, 1939–40 (2005); Noel B. Cunningham and James R. Repetti, *Textualism and Tax Shelters*, 24 Va Tax Rev 1, 2–4 (2004).

94 See, for example, David P. Hariton, *How to Define "Corporate Tax Shelter,"* 84 Tax Notes 883, 892 (1999).

95 See, for example, Chirelstein and Zelenak, 105 Colum L Rev at 1942, 1942–46 (cited in note 93) ("Tax shelter arrangements are inevitably complex and detailed—often by design."); Joseph Bankman, *The Tax Shelter Battle*, in Henry J. Aaron and Joel Slemrod, eds, *The Crisis in Tax Administration* 9, 13 (Brookings 2004) ("The complexity [of aggressive tax shelters] may be a necessary element of the shelter, but it also serves as a screen against governmental detection and public scrutiny.").

knit communities that produce social norms and to long-term relationships that give rise to self-enforcing agreements. Yet, on closer analysis, it is clear that the transactors described in all these examples belong to environments that have many, if not most, of the features conducive to the development of self-enforcing contracts and contractual norms.

These features are well developed in the literature: repeat players, multifaceted interactions, the easy dissemination of accurate information, and a credible threat of informal sanctions.[96] To take just one example, financial institutions and hedge funds interact with each other over time, not just on a one-off basis, so they are repeat players. They enter into a wide variety of contracts and relationships, with loan originations being just one example.[97] Information travels well among banks because the bankers talk to each other and often move from one bank to another. The same is true of the hedge fund managers. Moreover, a relatively small number of law firms act as primary counsel to the major financial institutions, and each law firm interacts with more than one bank. Thus, lawyers are perfectly positioned to assist their bank clients in spreading the word about any deviant behavior by hedge funds. The same mechanism helps hedge funds to stay informed about any opportunistic actions by banks. In fact, some law firms represent both sides of the table (in different transactions, of course). These firms are the ultimate information intermediaries.[98]

Finally, the threat of informal sanctions is very real. The hedge funds are among the banks' most prized clients because they enter into numerous trades, allowing the banks to earn high fees.[99] Losing several hedge funds to a competitor is a serious concern for any bank. At the same time, hedge funds need banks to operate. If a particular fund violates a tacit understanding and harms a given bank by not purchasing a loan participation, the fund will find it difficult to continue its relationship with *any* bank, at least on equally favorable terms. The bank that suffers a loss will be quick to retaliate by disseminating truthful negative gossip about the incident, and other

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96 See, for example, Ellickson, *Order without Law* at 181 (cited in note 4) (defining close-knit groups in which strong norms emerge as having "credible and reciprocal prospects for the application of power [among members] and a good supply of information on past and present internal events").

97 For a detailed discussion of another example, see text accompanying notes 102–16.

98 Many of the same features—including the relatively small number of players and the role of legal advisers in disseminating information—characterize the tax shelter market. See Braithwaite, *Markets in Vice* at 109, 116 (cited in note 47).

99 See, for example, Sheppard, 108 Tax Notes at 735 (cited in note 72) ("Hedge funds are the best customers of commercial banks and investment banks. They borrow heavily and pay a lot of fees for prime brokerage as they churn their portfolios. More importantly, they stand ready to buy loans that banks want to get rid of.").

banks (who are equally vulnerable to defections by any given hedge fund) will, no doubt, take this information into account when dealing with the norm violator. In other words, both banks and hedge funds can credibly threaten to punish deviant members of the norm environment without resorting to the legal system. At the same time, the use of legal sanctions is unlikely. If a bank refuses to sell a loan tranche at the day-of-origination price two days after the loan was originated, a hedge fund that asserts in court that there was an oral contract to that effect would seriously jeopardize its own tax planning. Even if the aggrieved party is a bank, insisting on the existence of an oral contract would not only harm the norm-violating hedge fund, but all of the bank's other hedge fund clients as well.[100] For all these reasons, it is not only possible, but almost inevitable, that these transactors will develop contractual norms.[101] The disturbing reality is that at least some of these norms will be tax driven.

If the confidentiality norm gives us a window into tax-driven norms, what about the Shasta County norm of neighborliness? Because it is not a contractual norm, its detailed consideration will come later. However, its salient feature—an incidental tax benefit—is typical of many contractual norms. These norms are considered next.

B. Tax-Relevant Norms

In the fall of 2005, the representatives of fourteen major financial institutions gathered at the Federal Reserve Bank of New York for a

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100 If a bank reveals the loan origination norm and insists that it gave rise to an oral contract between the bank and a specific hedge fund, the IRS will more likely become interested in the arrangement and the government will more likely prevail in arguing that similar oral contracts based on this norm exist between the bank and all of its other hedge funds clients who have purchased loan participations following a two-day delay.

101 The emergence of the confidentiality norm is more difficult to explain. Solving the commitment problem in this setting is particularly challenging because a client who violates the norm and discloses the tax shelter proposed by Promoter 1 to a competing Promoter 2 directly benefits Promoter 2. The same is not true of the VPFs, hedge fund lending, and cross-border swaps. In these cases a client that breaks the unstated rule imposes a cost on her counterparty bank while no other bank benefits. It is unclear how durable the confidentiality norm is, and some practitioners have opined that, while they were aware of the norm, they did not believe that it was particularly strong. What unites all examples of tax-driven norms, however, is that as soon as the information about the norm violation is disseminated, all banks and promoters will view the defecting client as an unreliable future partner. This is true even of Promoter 2. In other words, after a client cheats on Promoter 1 for the benefit of Promoter 2, Promoter 2 may be reluctant to trust that client with its own valuable tax planning idea for fear that the client will reveal it to Promoter 3 (or Promoter 1, for that matter). In addition, even though Promoter 2 has no incentive to inform Promoter 1 about the client's defection, once Promoter 2 starts marketing the shelter to other clients, Promoter 1 will learn (sooner or later) about the client's norm violation. See text accompanying notes 55–56.

somewhat unpleasant meeting.[102] The Federal Reserve was concerned that these banks had entered into billions or even trillions of dollars in trades without any adequate documentation to show for it. The characters in this story are familiar—the major banks and hedge funds. And the explanation behind the "inexplicable" carelessness of these sophisticated financial players is by now predictable: contracts (or, at least, complete contracts) were absent because the parties were comfortable relying on an informal norm.

The trades discussed at the meeting involved another derivative—a credit default swap (CDS). While CDSs may be structured in a variety of ways, the basic contract provides for periodic payments from one party (the protection buyer) to another (the protection seller) based on a notional amount in exchange for a protection buyer's right to sell the reference obligation to the protection seller for its face value (that is, above its market price) upon a default by the reference entity.[103]

In recent years, hedge funds have become active CDS protection buyers and sellers.[104] Financial institutions, primarily the fourteen that met with the New York Fed, have become their main counterparties. The volume of CDS trades is large,[105] and the pace at which hedge funds enter into them frantic.[106] To complicate things further, hedge funds frequently "novate" their CDS positions, that is, assign their rights and obligations under a particular swap to a third party (usually another swap dealer).

A set of standard contracts developed by the International Swaps and Derivatives Association (ISDA) is widely available to document

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102 See generally Lee A. Sheppard, *Tax Officials Discuss Financial Products at NYSBA Meeting*, 110 Tax Notes 446 (2006).

103 See, for example, NY State Bar Association Tax Section, *Report on Credit Default Swaps* 4–6 (2005), reprinted in 109 Tax Notes 347, 350–51 (2005). Sometimes, the protection buyer's right vests upon other specified events indicating a decline in the creditworthiness of the reference entity, such as a ratings downgrade. See NY State Bar Association Tax Section, *Report on Credit Default Swaps* 4–6. Some CDSs are cash settled, that is, the protection seller pays the protection buyer an amount that represents the decline from par in the fair market value of the reference obligation that occurred as a result of the credit event. Id. Most CDSs are physically settled (that is, by delivery of a reference obligation). Id at 6 (noting that "[o]ne recent survey reports that more than three-fourths of credit derivatives settle through physical settlement").

104 See NY State Bar Association Tax Section, *Report on Credit Default Swaps* at 32 (cited in note 103).

105 The market has grown from about $200 billion in outstanding notional value in 1999 to $12.5 trillion in June 2005. Kenneth Raisler and Lauren Teigland-Hunt, *How ISDA Took on the Confirmations Backlog*, 25 Intl Fin L Rev 43, 43 (2006).

106 See Timothy F. Geithner, *Remarks at the Bond Market Association's Annual Meeting in New York City* (Federal Reserve Bank of New York Apr 20, 2005), online at http://www.newyorkfed.org/newsevents/speeches/2005/gei050420.html (visited Apr 17, 2007).

CDSs.[107] Why, then, did the banks and hedge funds do business without adequate documentation? The risk they took was hardly theoretical. Several recent bankruptcies triggered payment obligations on some CDSs,[108] obligations that, in some instances, were not clearly enforceable.[109] To be sure, the CDS business did not operate completely by word of mouth. The parties almost certainly kept electronic records of their trades, and they did document most of their contracts eventually. However, in the words of the New York Fed president, the backlog of unconfirmed trades was "very substantial."[110]

Most market participants believe that these poor documentation practices were a sign of a developing market. Initial CDS documents offered by ISDA were insufficiently flexible. "Back office" systems of financial intermediaries were not ready for the volume and pace of the CDS trading. At the same time, the extremely strong demand for these derivatives put tremendous pressure on everyone involved to find a way of trading CDSs quickly and effectively. The solution was to do deals by documenting only the most basic terms and to rely on the parties' reputation for residual protection.

What makes the CDS story particularly interesting for our purposes is that the failure to properly document these swaps had a likely tax effect, albeit not a major one. Tax characterization of these derivatives remains uncertain. It is somewhat unclear whether CDSs fit the

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107 See NY State Bar Association Tax Section, *Report on Credit Default Swaps* at 5 (cited in note 103).

108 See, for example, *Deutsche Bank AG v AMBAC Credit Products, LLC*, 2006 US Dist LEXIS 45322, *13–16 (SDNY) (addressing a controversy arising from the bankruptcy of an issuer of a CDS reference obligation and referring to eight prior bankruptcies of CDS reference entities).

109 For instance, the basic ISDA documents often remained unsigned. See, for example, Geithner, *Remarks at the Bond Market Association's Annual Meeting* (cited in note 106) (attributing the failure to sign to an ostensible backlog of documents). Some CDSs were novated without notifying a counterparty despite an express prohibition in the standard ISDA documents against assignments without the counterparty's express written consent. See Raisler and Teigland-Hunt, 25 Intl Fin L Rev at 44 (cited in note 105):

> Some [interested parties] argued that novations are simply a form of transfer or assignment of a transaction and therefore are prohibited by Section 7 of the Isda Master Agreement in the absence of the remaining party's written consent. Others maintained that novations are new transactions formed between the transferee and remaining party and therefore they are binding on oral agreement and are not subject to the anti-assignment clause of the Isda. Still others submitted that remaining parties should be bound by their oral consent to a novation, just as parties to new transactions are bound by oral agreement, regardless of whether novations are considered to be transfers or new trades.

The issue is hardly insignificant. By some estimates, novations represent 40 percent of the CDS market's trading volume. Id at 43.

110 Timothy F. Geithner, *Remarks at the Institute of International Finance, Inc.'s Annual Membership Meeting in Washington, D.C.* (Federal Reserve Bank of New York Sept 25, 2005), online at http://www.newyorkfed.org/newsevents/speeches/2005/gei050925.html (visited Apr 17, 2007).

NPC definition for tax purposes.[111] If they do, no tax is due on periodic payments received by an offshore hedge fund from its U.S. counterparty under a CDS.[112] Moreover, a hedge fund acting as a protection seller in a CDS with a U.S. counterparty is not viewed as conducting an insurance business in the United States.[113] If, however, a CDS is characterized as a guarantee or an insurance contract, this tax-favorable treatment is unavailable.[114] Even strong proponents of the NPC characterization acknowledge that at least some CDSs are probably not NPCs for tax purposes.[115]

Granted, the form chosen by a taxpayer does not necessarily determine the tax treatment of a transaction. However, it is clearly one of the relevant considerations.[116] By not documenting their CDSs promptly using the forms typical for NPCs, the hedge funds probably *weakened* their argument that these swaps were NPCs for tax purposes. Thus, the choice of doing the CDS business based on a contractual norm affects the tax analysis of the transaction. Because the effect favors the government, this norm is clearly not tax driven. But the effect is present nonetheless, making the choice between a contract and a norm relevant to the tax inquiry. Therefore, the "CDS norm," and other norms with the same features, are "tax-relevant" norms.

Not all tax-relevant norms disadvantage taxpayers. One contractual norm that is taxpayer favorable but most likely not tax driven has produced decades of litigation and a number of judicial decisions whose meaning and scope remain unclear. The troublesome transaction is the so-called sale-and-repurchase agreement, or repo. It was developed in the 1920s,[117] and it remains a major part of today's money

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111 The government solicited taxpayers' views on the subject, see Notice 2004-52, 2004-32 Int Rev Bull 168, 169, but has issued no guidance so far, and none is expected in the near future. See Sheppard, 110 Tax Notes at 447 (cited in note 102) (citing an IRS lawyer's indication that "the government did not have enough information about credit default swaps to determine classification"). For a detailed analysis of the tax treatment of CDSs, see NY State Bar Association Tax Section, *Report on Credit Default Swaps* at 32–62 (cited in note 103).

112 See NY State Bar Association Tax Section, *Report on Credit Default Swaps* at 34 (cited in note 103).

113 See id.

114 See id.

115 See id at 51–52.

116 It is no accident that the New York State Bar Association Tax Section suggested that documenting a CDS on the standard ISDA forms should be one of the requirements for a CDS to fall within the Section's proposed safe harbor. See id at 2.

117 See, for example, *First National Bank in Wichita v Commissioner of Internal Revenue*, 57 F2d 7, 7–8 (10th Cir 1932) (quoting a repo agreement used prior to November of 1922); *Bank of California, NA v Commissioner of Internal Revenue*, 30 Bd Tax App 556, 556–57 (1934) (referring to repo trading in 1928 and 1929). See also Marcia Stigum, *The Repo and Reverse Markets* 81–87 (Dow Jones–Irwin 1989) (describing the origins of repo markets in the 1910s–1920s).

markets.[118] A repo is a hybrid—a combination of two outright sales that has the effect of a loan. To illustrate, a repo seller, such as a bond dealer, sells government bonds to a repo buyer, such as a commercial bank, and simultaneously agrees to repurchase them on a fixed future date or on either party's demand. The repurchase price has nothing to do with the fair market value of the bonds, but is calculated based on their initial sale price increased by an interest charge. As a result, the parties' positions are very similar to those of a lender (the bank) and a borrower (the dealer) who have entered into a loan secured by the repo'd bonds.[119]

Repos became a thorn in the Commissioner's side because some of the repo'd bonds were municipal securities that paid interest exempt from federal income tax.[120] The repurchase price of these repos was exactly the same as the original sale price, but the banks were allowed to retain the tax-exempt interest. As long as these repos were taxed according to their form, the banks received tax-free interest on what were essentially loans to municipal bond dealers. If the banks actually lent the same funds to the dealers, the interest they received would be fully taxable. Because the bond dealers were indifferent between these two alternatives, structuring the transaction as a repo rather than a secured lending reduced the banks' taxes without any cost to their dealer counterparties.[121]

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118 See, for example, Marcia Stigum, *The Money Market* 575 (Dow Jones–Irwin 3d ed 1990) ("Over the last several decades, the repo market has become one of the biggest sectors in the U.S. money market.").

119 The bank provides the bond dealer with cash equal to the purchase price and receives it back with interest, and the bond dealer retains economic exposure to the bonds even while the bank is their nominal owner.

120 See, for example, *Bank in Wichita*, 57 F2d at 7.

121 Imagine, for simplicity, a bond dealer who wants to purchase for its inventory a par $100 municipal bond that trades at par and pays monthly interest of $2. In the first instance, the dealer borrows $100 from a bank, also at 2 percent per month. The interest received on the municipal bond is not taxable due to a specific exemption in the Internal Revenue Code. 26 USC § 103(a) (2006) (stating that, with some exceptions, "gross income does not include interest on any State or local bond"). While business interest is generally deductible, 26 USC § 163(a), (h)(2)(A) (2006), a special provision present in the Code since at least 1918 denies the deduction for interest "incurred or continued to purchase or carry" tax-exempt securities such as the bond in our example. 26 USC § 265(a)(2) (2006). See also *Phipps v Bowers*, 49 F2d 996, 997 (2d Cir 1931), citing The Revenue Act of 1918 § 214(a)(2), 40 Stat 1057, 1066–67. Thus, the bond dealer neither includes the $2 received on the bond in income nor deducts the $2 paid to the bank. Because the interest paid and received is the same, the dealer neither gains nor loses financially. The bank, on the other hand, receives $2 in interest from the dealer and is fully taxed on it.

Consider now what happens if instead of borrowing $100 from the bank, the dealer sells the same bond to the bank for $100 under a repo and uses that $100 to pay (with a slight delay) the purchase price of that very bond. The repurchase price is also $100, and the bank is allowed to retain the $2 monthly interest paid on the bond. As before, the dealer has neither financial nor tax consequences, this time because the dealer neither receives interest on the bond nor pays interest to the bank. Therefore, the dealer is indifferent between the two financing mechanisms.

Needless to say, the IRS persistently argued that under the substance-over-form principle a sale combined with an agreement to repurchase for a fixed price was nothing but a secured loan.[122] This argument, however, skipped over an inconvenient detail. Repos had no actual repurchase agreements. Often, a bank had a contractual right to sell the repo'd securities to a dealer for a fixed price (a put option).[123] Sometimes, the dealers had a right to repurchase the bonds for a fixed price (a call option).[124] Occasionally, the entire transaction was done without written documentation.[125]

As a result, depending on the particular variation, one or both parties exposed themselves to risk. In a declining interest rate environment, the municipal securities would increase in value and a bank could refuse to resell them at what would then be a below-market price, unless the dealer had a call. In a rising interest rate environment, the repo'd securities' value would drop, and a dealer could refuse to repurchase them, unless the bank had a put. Assuming the world did not stand still during the repo's term, one of these scenarios was bound to unfold. How could the parties operate amidst such uncertainty?

They did not. Instead of relying on formal, written, legally enforceable agreements, repo buyers and sellers did business based on a contractual norm. All involved understood what was expected, and (almost) everyone performed according to expectations. The municipal bonds were resold for their initial sale price whether it was above or below market at the time of the resale. As long as a bank or a bond dealer planned to continue in the repo business, this norm was no less binding than the most unassailable written contract.

The bank, however, has a clear preference. Unlike the $2 interest received from the dealer, the $2 interest the bank collects on the bond is exempt from tax. As long as the repo's form is respected and the bank is treated as the owner of the municipal bond, a repo allows the bank to earn tax-free interest on the funds it lent to the bond dealer.

122 See, for example, *First American National Bank of Nashville v United States*, 467 F2d 1098, 1100 (6th Cir 1972); *Union Planters National Bank of Memphis v United States*, 426 F2d 115, 116 (6th Cir 1970); *American National Bank of Austin v United States (Bank of Austin I)*, 421 F2d 442, 444 (5th Cir 1970); *American National Bank of Austin v United States (Bank of Austin II)*, 573 F2d 1201, 1205 (Ct Cl 1978); Rev Rul 74-27, 1974-1 Cum Bull 24, 25.

123 See, for example, *Bank of Memphis*, 426 F2d at 116 ("[A]ppellant Bank has purchased municipal bonds from local bond dealers, subject to agreements permitting the Bank to require repurchase by the dealer at any time at the price paid by the Bank.").

124 See, for example, *Bank of Austin II*, 573 F2d at 1204 ("[T]he bond dealer would have an option of indefinite duration to acquire the bonds from the plaintiff at the same price which the dealer had originally bid on the bonds [plus additional fees].").

125 See, for example, id at 1203 (noting that agreements between the bank and local bond dealers might be "oral only"); *Bank of Nashville*, 467 F2d at 1100 (describing an oral repo agreement); *Sheldon v Commissioner of Internal Revenue*, 94 Tax Ct 738, 743 (1990) ("[D]uring the early 1980's ... parties generally entered into repos only on the basis of oral agreements with follow-up written confirmations from contra-parties.").

At first blush, the "repo norm" surely smells like tax planning. Taxing repos according to their form produced clear tax benefits for the lending banks (repo buyers). The absence of an actual repurchase agreement made it more difficult for the IRS to recast the transaction as a loan under the substance-over-form principle. All the trappings of a tax-driven norm appear to be in place.

Yet the repo norm was almost certainly not tax driven. The repo litigation revealed that the earliest repos *did* include written repurchase agreements. The market moved to a partially informal arrangement because of a problem with banking regulators. From their inception, repos gave banks a mechanism to extend credit in amounts greatly exceeding the lending limits imposed by the Comptroller of the Currency.[126] This worked, of course, only as long as the Comptroller respected the repos' form. In 1922, the Comptroller informed one of the banks that it viewed a fully documented repo as a loan, putting the bank in violation of its lending limits.[127] The solution developed by the bank in consultation with the regulator was to replace a repurchase agreement with something less certain. The Comptroller concluded that:

> [The revised repurchase] agreement is satisfactory, inasmuch as the [bond dealer] merely has the privilege of repurchasing the bonds referred to, and does not bind itself absolutely so to do. If the [bond dealer] could be compelled to repurchase these bonds, the transaction would then be a loan subject to the limit prescribed by [federal statute].[128]

The revised "repurchase" agreement satisfied the Comptroller of the Currency, but changed little as far as the business needs of the parties. They adapted by replacing an explicit repurchase term with an implicit contractual norm. While this norm indeed arose to circumvent a regulatory problem, the regulations had nothing to do with tax.[129]

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126 For instance, the First National Bank in Wichita, involved in one of the early repo controversies, could lend only up to $200,000 to a single customer. *First National Bank in Wichita v Commissioner of Internal Revenue*, 19 Bd Tax App 744, 746 (1930). Financing indirectly through repos allowed it to extend up to $6 million in credit to a single customer. Id.

127 Id at 746.

128 *Bank in Wichita*, 57 F2d at 8. One can question whether the bond dealer's obligation to reimburse the bank for any loss incurred in connection with a repo is the economic equivalent of a repurchase guarantee, but the important conclusion for our purposes is that the Comptroller insisted on the absence of a written repurchase agreement as a condition of respecting the repo's form.

129 There is a further reason to suspect that the repo norm was not tax driven. A repo is tax advantaged only if the repo'd security is tax exempt. If the repo'd security in the previous example is a taxable corporate bond, the bank would have the same $2 in taxable interest income whether it lends $100 to the dealer or purchases the bond from him under a repo and retains the interest. The reason why the securities used in the repos litigated by the IRS were invariably tax exempt, however, was not tax planning. Not only were the banks restricted in the amount of credit they could extend to a single customer, they were also constrained in the kinds of assets

Moreover, when repo markets reverted to fully formalized repurchase contracts in the mid-1980s, they did so not because several appellate courts held that repos should be taxed as secured loans despite the absence of formal repurchase agreements.[130] Rather, the markets abandoned the repo norm to clarify the uncertain legal status of repos highlighted by a high profile bankruptcy.[131] Thus, like the neighborly interactions among the Shasta County locals, repos were a case where the potential tax benefit was an incidental windfall that accompanied a transaction shaped by other considerations. The repo norm was tax relevant, but not tax driven.

C. Tax-Neutral Norms

I will term the third type of contractual norms "tax neutral" because whether the informal agreements underlying these norms remain unstated or are incorporated into the related written contracts makes no difference to the tax analysis. An idiosyncratic but colorful example of a tax-neutral norm is a custom developed by American grain merchants. Their contracts often require the parties to use official weights.[132] These weights are expensive, however, and the custom is to use unsupervised in-house weights instead.[133] The custom flatly contradicts the express contractual term, but this has no tax effect. If the contracts were rewritten to allow the use of in-house weights, or if they were interpreted by the IRS to allow this, no tax consequences would follow. The norm is neutral with respect to the tax law.

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they could hold. At least in the 1920s when the market practice developed, municipal securities constituted "approved banking investments," *Bank in Wichita*, 19 Bd Tax App at 748, so the banks could acquire them in large quantities without running afoul of banking regulations. It is also worth noting that over the years, repos have been used in clearly tax-motivated transactions. But these tax strategies were not based on treating a repo according to its form, so the repo norm was not used to achieve a tax advantage. See, for example, *Sheldon*, 94 Tax Ct at 758 (denying tax benefits arising from repos designed to "facilitate the interest deduction in the first year and the mismatched reporting of the related income in the next," and concluding that the ultimate holding "obviates the need to decide [whether repos] represent sales or secured collateralized loans"). For another example of how contractors use informal arrangements to avoid burdensome regulations, see Palay, 1 J L, Econ, & Org at 164–65 (cited in note 15) (describing how railway carriers and manufacturers shipping their goods by rail avoided Interstate Commerce Act rules through informal agreements that operated alongside official contracts).

130 A series of appellate decisions adopting the IRS's view of repos as secured loans predates the abolition of the repo norm by a full decade. See note 122.

131 See Stigum, *The Repo and Reverse Markets* at 218–21 (cited in note 117) (describing the 1982 Lombard-Wall bankruptcy and the development of a new standardized repo agreement).

132 See Bernstein, 144 U Pa L Rev at 1799 (cited in note 9).

133 See id.

Another example of a tax-neutral norm comes from the famous antitrust case of *United States v United Shoe Machinery Corporation*.[134] Shoemaking machines produced by the defendant were extremely complex pieces of equipment, and the likelihood that they would need repairs was high. United Shoe and other manufacturers leased their machines to the end users, and the lease contracts specifically provided that the lessees bore the repair and maintenance costs.[135] The informal norm, however, was very different. When United Shoe fixed its machines, it usually charged the lessees only the cost of replacement parts.[136] Again, whether the written lease placed the repair and maintenance costs on the lessor or lessee had no effect on the tax analysis.

This informal practice is one example of a broader contractual norm. Researchers have found that businesses routinely repair or replace their products beyond the stated warranty periods.[137] Manufacturers may even deliberately shorten the warranty coverage to deal with the moral hazard problem, expecting to go beyond the stated term in most cases.[138] Whether a contract has a three-year or a ten-year warranty makes no difference to the tax treatment of either party to the contract. The norm to repair defective products beyond their stated warranty periods is tax neutral.

The proposed categories of tax-driven, tax-relevant, and tax-neutral norms will help to analyze the costs of different government responses to norm-based tax planning. Before considering these costs, however, an admission is in order. While the proposed categories are useful, nothing in real life is as neat as a three-category scheme. The difficult cases are considered next.

D. Difficult-to-Classify Cases

Challenges with categorizing some contractual norms arise for two reasons. First, the same norm may fall into a different category

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134 110 F Supp 295, 342–46 (D Mass 1953) (holding that United Shoe violated the Sherman Act by engaging in anticompetitive leasing and other practices).

135 See Scott E. Masten and Edward A. Snyder, United States versus United Shoe Machinery Corporation: *On the Merits*, 36 J L & Econ 33, 62 (1993). While the defendant in the case dominated the market, more than eighty firms competed with United Shoe in some fashion, and there were twenty-two known competitors for its major machines. See id at 40.

136 Id at 63. Most likely, this was an industry-wide custom. United Shoe was the dominant player and almost certainly set the market norm. In addition, an officer of Compo, United Shoe's main rival, testified at trial that the shoemaking machine manufacturing industry was really a service industry designed to assure successful shoemaking by the lessees. Id at 41.

137 See, for example, Beale and Dugdale, 2 Brit J L & Socy at 57 (cited in note 16) ("[T]here is clearly strong pressure on a seller [of manufactured goods] to stand behind his product especially if he is hoping to make further sales, and all sellers said that in some circumstances they would repair or replace a defective product outside the warranty period.").

138 Id.

depending on the specific setting. Second, the norm of mutual cooperation and support among family members defies categorization.

Consider, for example, a widespread custom of agreeing to terminate a contract upon the counterparty's request if the termination is not particularly costly.[139] Of course, total strangers who are unlikely to interact again or who have entered into a large transaction will not be particularly accommodating. But repeat players who care about their reputations behave differently. They do not view a cancellation as a contractual breach. Rather, they "believe that there is a right to cancel as part of the buyer-seller relationship. There is a widespread attitude that one can back out of any deal within some very vague limits."[140] Where does this "reasonable cancellation norm" fit in the proposed classification? That is, would the tax analysis change if the parties expressly incorporate it into the contract?

In many cases, the answer is likely to be "no." Whether the parties sign a contract to deliver a fixed quantity of goods on a fixed date, or an otherwise identical contract that gives each side a right to terminate as long as the other party has not incurred costs in excess of a certain threshold, the tax consequences are exactly the same. As long as this is true, the norm is tax neutral.

This analysis, however, does not hold for all contracts. If a contract that is terminable at will happens to be a swap, its tax characterization as an NPC is in doubt. A notional principal contract must provide for a series of periodic payments. Presumably, these payments must be more than mere possibilities. If so, the tax treatment of a swap may well depend on whether the norm remains unstated or is expressly incorporated into the written agreement. Thus, if the reasonable cancellation norm accompanies a swap contract, it is tax relevant.

As we have seen, it is quite possible that this norm does accompany swap contracts. Not just any swaps, but equity swaps with foreign counterparties. Foreign traders and financial institutions rely on this norm to allow the traders to change their positions in U.S. equities as often as they wish while avoiding the withholding tax on the dividend-equivalent payments. In this context, the reasonable cancellation norm is tax driven.

Another example of a difficult-to-classify norm also relates to some already familiar market practices. This norm allows businesses to transact without waiting until all formalities are observed. Business partners often rely on informal promises to enter into contracts on

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139 See Weintraub, 1992 Wis L Rev at 20 n 60 (cited in note 16); Beale and Dugdale, 2 Brit J L & Socy at 52–53 (cited in note 16); Macaulay, 28 Am Sociological Rev at 61 (cited in note 16).

140 Macaulay, 28 Am Sociological Rev at 61 (cited in note 16) (quoting an experienced lawyer with many large industrial clients).

(mostly) agreed-upon terms.[141] I will refer to this practice of doing deals on the strength of a partner's word (rather than her signature) as a "deal now/sign later norm."[142]

In many cases, it would make no difference for tax purposes whether a contract is entered into when the informal agreement is reached or later, when the documents are signed. Thus, sometimes the deal now/sign later norm is tax neutral. Sometimes, but not always. In fact, the (excessively) heavy reliance on this norm by the swap-dealer banks and hedge funds drew the scrutiny of the New York Fed to the CDS business. The norm is tax relevant for these parties because the manner in which a CDS is documented affects its tax characterization.[143]

If a norm may be tax relevant, there is a potential that it will be used in tax planning. Consider again how offshore hedge funds are able to come close to initiating loans to U.S. borrowers without becoming subject to U.S. tax. Lead banks originate loans on an understanding that the hedge funds will purchase loan tranches for a fixed price that is almost certain to be above or below the market. The parties act just as if they agree on the sale of the loan tranche when the loan is originated, but document the sale a few days later. Here, however, the delay is not due to the businesspeople's inattention to paperwork. Rather, it is a deliberate tax minimization technique. The

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141 Lisa Bernstein has reported that cotton traders do "millions of dollars of business ... on the basis of a thirty-second phone call." Bernstein, 99 Mich L Rev at 1746 (cited in note 10) (quoting a cotton merchant and former Board of Agriculture arbitrator). Some of these traders delay formalizing their agreements for up to seven or ten days. See id. Willingness to do business before any legally enforceable documents are signed is hardly a recent phenomenon. A study of Connecticut companies reported in 1957 that out of eighty-seven respondents, ten never requested written confirmations of their customers' orders, and sixty-five of the remaining seventy-seven frequently commenced production before receiving such confirmations. See Comment, 66 Yale L J at 1052–55 (cited in note 16).

142 Needless to say, sometimes the norm is not followed. After one party starts "dealing" (that is, makes an investment before signing an enforceable contract), the other may refuse to "sign." For a review of such cases, see Alan Schwartz and Robert E. Scott, *Precontractual Liability and Preliminary Agreements*, 120 Harv L Rev 661, 671–73 (2007) (reviewing 105 recent cases where one party made a reliance investment in anticipation of the other party's cooperation, but the other party refused to cooperate). Yet we should not underestimate the ubiquity of the deal now/sign later norm by generalizing from the relatively few instances where cooperation broke down. See Scott, 103 Colum L Rev at 1645 (cited in note 17) ("[T]he occasional failure of self-enforcement provides little guidance for how the law should treat the far greater number of instances where reciprocity may well be the more efficient mechanism for making credible promises.").

143 The same norm is also tax relevant for contracts that are marked to market, that is, taken into account for tax purposes at fair market value at the end of each tax year. Securities and commodities dealers and traders may (and, in some cases, must) account for their contracts in this manner. 26 USC § 475 (2006). An informal agreement struck just before the tax year ends would not be marked to market. Had it been fully documented at that point (rather than a week or a month into the following tax year), a change in its value would have been reflected in the annual mark.

deal now/sign later norm is tax driven in this setting. Of course, exactly the same dynamic describes the VPF stock lending norm.

Turning to the norm of mutual cooperation and support among family members (the "family commitment norm"), one thing about it is clear: it did not arise to reduce family members' taxes. If nothing else, it predates the U.S. income tax by a few centuries. It is also apparent that this norm usually operates in an entirely informal environment. However, the family commitment norm occasionally accompanies explicit contracts between family members[144] or other formal arrangements among them.[145] Thus, sometimes it functions as a contractual norm. When it does, it often has no bearing on tax liabilities; that is, it is tax neutral. However, as the proliferation of the related party rules in the Internal Revenue Code amply demonstrates, Congress has realized that the family commitment norm has a strong potential to be used in tax planning.[146] In other words, it can be tax driven.

Categorizing the family commitment norm is difficult not because, like the reasonable cancellation norm, it produces more specific subsidiary norms with diverging tax effects, but because its direct use may give rise to all sorts of tax consequences or to none at all. Overstating only somewhat, the same implicit norm that would jolt my stepmother into action if I needed her help because I became sick or injured would also guide her decisions if I asked her to hold some stock that I "sold" to her to realize a tax loss.[147] Thus, the contractual family commitment norm may be tax neutral, tax relevant, or tax driven depending on the specific circumstances.

E. Drawing Preliminary Conclusions

It would be foolish to make conclusive generalizations from this initial consideration of the tax effects of contractual norms. However, some preliminary suggestions appear to be warranted, at least as hypotheses.

First, contractual norms differ in their tax effects. Some have no such effects; they are tax neutral. Other norms have tax consequences, but these are taxpayer-favorable or -unfavorable side effects, not the reason for the norms' existence. These are tax-relevant norms. Finally,

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144 See, for example, *Lucas v Earl*, 281 US 111, 111 (1930); *Estate of Craft v Commissioner of Internal Revenue*, 68 Tax Ct 249, 250 (1977).

145 For instance, family members are often shareholders in a family-controlled corporation or partners in a family partnership. "As everyone knows, business is frequently a family matter." Posner, *Law and Social Norms* at 151 (cited in note 23).

146 See text accompanying notes 175–79.

147 Note that the related party rules of 26 USC § 267(a)(1), (b)(1), (c)(4) (2006) (disallowing deductions for losses from sales of property to "brothers and sisters . . . spouse, ancestors, and lineal descendants"), which would defeat this strategy in most cases, do not apply to stepparents.

there are contractual norms that develop solely (or primarily) to achieve a particular tax result. These tax-driven norms remain unstated precisely because their documentation would increase the tax liability of those who use them. In many cases, the same norm may fall into some or all of these categories, depending on the circumstances.

Second, the business world relies heavily on several relatively generic contractual norms. These, in turn, are adopted by contractors in various settings, becoming further specified in the process. Thus, hedge funds and syndicating banks rely on their version of the deal now/sign later norm to delay the sale of loan tranches for forty-eight hours. Cotton traders use this norm to defer documenting their trades for up to ten days.[148] Wealthy individuals entering into VPFs with bank counterparties adopt the same norm to postpone stock lending for one to three months. And hedge funds and swap-dealer banks rely on their adaptation of the deal now/sign later norm to defer formalizing CDSs for even longer periods. The maximum (and, in some cases, the minimum) acceptable gap between entering into an informal agreement and putting it in writing varies, making the specific norm different from case to case. But the broader underlying norm remains the same. We may think of "families" of norms that start with the most general ones and expand to increasingly specific norms adopted in particular norm environments.

Third, it is misguided to even attempt to assign a norm to one of the suggested categories unless the norm is fairly specific. To take the opposite extreme, consider the norms used by game theorists in modeling informal group interactions. There are usually only two—cooperate and defect. These norms are so generic that they may underlie an infinite variety of particular customary rules. It is utterly impossible to analyze the tax consequences of these abstract norms. The situation is not much different if we consider the relatively generic reasonable cancellation and deal now/sign later norms. We have seen how they may be adapted to produce more specific norms falling in any of the three categories.

Finally, while the gradual norm specialization mechanism appears to be widespread, it is not universal. Because the family commitment norm operates in various settings in a largely unaltered form, it cannot be pigeonholed into any particular category.

The emerging picture is quite complicated. What should the government do about contractual norms? Maybe nothing. If the current law effectively and comprehensively deals with the problem, why look for alternatives? Even a cursory inspection reveals, however, that the

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148 See Bernstein, 99 Mich L Rev at 1746 (cited in note 10).

current law's treatment of informal arrangements is neither effective nor comprehensive. In fact, it is unclear what this treatment is at all.

III. THE UNCERTAIN TAX TREATMENT OF CONTRACTUAL NORMS

The repo controversy presented the courts with a golden opportunity to consider how the tax law should take account of contractual norms. Unfortunately, the courts failed to take advantage. They implicitly treated the repo norm as a legally binding obligation, yet they did not expressly acknowledge this decision. More importantly, the courts failed to analyze the factors justifying their approach, did not discuss countervailing considerations, and made no efforts to delineate the precise scope of their holdings.

The repo decisions appear to run against the Tax Court's approach to so-called extrinsic evidence—information used by contracting parties but not reflected in the express contract terms and typically excluded by the parol evidence rule. The court reconciled its earlier inconsistent precedents by distinguishing two uses of extrinsic evidence.[149] In cases where the issue is the proper character or allocation of amounts received under a written agreement, the parol evidence rule is inapplicable and the court is free to consider extrinsic evidence.[150] On the other hand,

> In those instances where [the court is] called upon to make a State law determination as to the existence and extent of legal rights and interests created by a written instrument, [it] must look to that State's parol evidence rule in deciding whether or not to exclude extrinsic evidence that bears on the disputed rights and interests under the instrument.
>
> To hold otherwise could conceivably lead to an *anomalous situation* in which, because we had admitted and found convincing parol evidence that would have been excluded by a State court, *we might determine and cause to be taxed certain interests and rights that a State court applying State law would find to be nonexistent.*[151]

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149 See *Estate of Craft v Commissioner of Internal Revenue*, 68 Tax Ct 249, 259–62 (1977).

150 Id at 263 (explaining that this approach is necessary "in order that we base our decisions on the substance of the documents before us rather than the form"). This conclusion makes perfect sense. For instance, why should the IRS be bound by the parties' allocation of the purchase price to a covenant not to compete that has no effect on either party's rights and obligations (other than their tax liabilities)? The allocation is part of the contract, to be sure, but it should not—and does not under *Estate of Craft*—bind the IRS. See id.

151 Id (emphasis added).

At least in the Tax Court, contractual norms that would be excluded under the parol evidence rule are not treated as legally binding provisions.[152]

To be sure, the parol evidence rule is not what it once was.[153] When construing contracts subject to the Uniform Commercial Code (UCC), and especially its Article 2 that covers sales of goods, courts liberally consult extrinsic evidence, including contractual norms that fall under the rubric of "usage of trade."[154] Yet many contracts are not for sale of goods, and some fall outside of the UCC's scope altogether. Those agreements are interpreted under common law rules that are much more formalistic.[155]

Furthermore, taxpayers may take a number of steps to make incorporating customary practices into their contracts more difficult for the courts. They may fortify a contract with a merger clause stating that the document expresses their entire agreement and that all their

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152 The circuit courts appear to be split, but their decisions are generally consistent with the reconciliation offered in *Estate of Craft*. Compare *Nance v United States*, 430 F2d 662, 663 (9th Cir 1970) (applying the parol evidence rule to exclude extrinsic evidence in a dispute about the rights of an owner of a life insurance policy); *Clark v United States*, 341 F2d 691, 693–95 (9th Cir 1965) (applying the parol evidence rule to exclude extrinsic evidence in a dispute about ownership of corporate equity); *Jurs v Commissioner of Internal Revenue*, 147 F2d 805, 808–09 (9th Cir 1954) (applying the parol evidence rule to exclude extrinsic evidence in a dispute about ownership of a partnership interest); *Pugh v Commissioner of Internal Revenue*, 49 F2d 76, 79 (5th Cir 1931) (applying the parol evidence rule to exclude extrinsic evidence in a dispute about the allocation of depletion deductions), with *Landa v Commissioner of Internal Revenue*, 206 F2d 431, 432 (3d Cir 1953) (finding the parol evidence rule inapplicable and admitting extrinsic evidence in a dispute about the tax characterization of payments as principal and interest or as alimony); *Scofield v Greer*, 185 F2d 551, 552 (5th Cir 1950) (finding the parol evidence rule inapplicable and admitting extrinsic evidence in a dispute about the tax character of alimony payments); *Stern v Commissioner of Internal Revenue*, 137 F2d 43, 45–46 (2d Cir 1943) (finding the parol evidence rule inapplicable and admitting parol evidence showing that money placed in an alimony trust by third parties was not taxable to the husband, but also reaching the same result on alternative grounds). It is worth noting that it is usually the government who invokes the parol evidence rule to exclude taxpayer-favorable testimony. One would think that courts would be more reluctant to rely on this rule when taxpayers use it to defend aggressive tax planning. Yet the analysis in *Estate of Craft* is decidedly symmetrical. See *Estate of Craft*, 68 Tax Ct at 259–63.

153 In Eric Posner's words, the parol evidence rule persists "despite the assaults of judges and commentators." Posner, *Law and Social Norms* at 163 (cited in note 23).

154 UCC § 2-205(2) (ALI 2005). See also Robert E. Scott, *The Uniformity Norm in Commercial Law: A Comparative Analysis of Common Law and Code Methodologies*, in Jody S. Kraus and Steven D. Walt, eds, *The Jurisprudential Foundations of Corporate and Commercial Law* 149, 163 (Cambridge 2000) ("The [UCC] explicitly invites incorporation [of contextual evidence] by defining the content of an agreement to include trade usage, prior dealings, and the parties' experiences in performing the contract.").

155 See Scott, *The Uniformity Norm* at 162–64 (cited in note 154) (detailing the "uneasy coexistence" of the formalist common law parol evidence rule with the UCC's embrace of evidence from outside the explicit language of contracts).

understandings are fully merged into it.[156] While this clause will not provide an absolute guarantee, it will discourage courts from looking at extrinsic evidence. A "no oral modification" clause has a similar effect (and is available even for the Article 2 contracts).[157] Contractors may further guard against the incorporation of a particular custom by including a contractual term that specifically contradicts it. Courts find it much easier to look outside of the four corners of the document to interpret an ambiguous provision or to add a missing term than to flatly disregard express contractual language. Finally, the taxpayers' greatest opportunity to prevent the incorporation of contractual norms comes from their freedom to choose the law of the contract. It is no secret that while some states have moved toward a more open-ended, contextual mode of contractual interpretation, others staunchly refuse to abandon the traditional formalism of the common law.[158] Simply adding a choice-of-law clause that subjects the contract to the law of a formalistic jurisdiction goes a long way toward ensuring that the contract will be interpreted as written.

In sum, taxpayers have ample means to prevent incorporation of their contractual norms into the terms of their written agreements. As long as the Tax Court adheres to its view quoted above, many contractual norms will remain outside of its inquiry.[159]

Beyond the questions of state law, courts in tax cases have struggled mightily with developing a coherent and uniform approach to informal understandings (whether bilateral or multilateral). No doubt, the existing authorities will give the government plenty of cases to cite if it attacks any of the tax-driven norms discussed above. But it is equally clear that the taxpayers will find many supporting precedents as well. Whether the implicit understandings were considered in the

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156 See, for example, Avery W. Katz, *The Economics of Form and Substance in Contract Interpretation*, 104 Colum L Rev 496, 508 (2004).

157 See id (noting, however, that courts may still use the equitable doctrines of waiver and estoppel, though they are less likely to do so), citing UCC § 2-209.

158 See, for example, Eric A. Posner, *The Parol Evidence Rule, the Plain Meaning Rule, and the Principles of Contractual Interpretation*, 146 U Pa L Rev 533, 538–40 (1998).

159 The leading tax treatise shares this conclusion:

> [I]t is quite obvious that written agreements are rarely, if ever, restructured for federal tax purposes in order to reinstate a prior, inconsistent understanding between the parties. For example, whether a purported lease should be treated for tax purposes as a sale is determined from the terms of the parties' agreement as written rather than from prior negotiations or understandings.

Bittker and Lokken, *Federal Taxation of Income, Estates and Gifts* at ¶ 4.4.5 (cited in note 86). Of course, the quoted passage turns in part on the fact that the prior understanding is *inconsistent* with the express writing. As we have seen with the confidentiality norm, this inconsistency is easy to create.

context of charitable donations,[160] family trusts,[161] interspousal transfers,[162] or corporate restructurings,[163] it seems that for every government win there has been a taxpayer-favorable decision.[164] In fact, even the government's record of litigating the tax treatment of repos is imperfect, with taxpayers winning on several occasions.[165]

In part, this inconsistency is a product of misleading rhetoric. The government's weapon of choice in dealing with informal understandings is the substance-over-form principle (and its narrower version, the step transaction doctrine).[166] The Supreme Court appears to give this principle a very broad reach:

> In applying this doctrine of substance over form, the Court has looked to the objective economic realities of a transaction rather than to the particular form the parties employed. The Court has

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160 Compare *Blake v Commissioner of Internal Revenue*, 697 F2d 473, 477–81 (2d Cir 1982) (IRS wins), with *Grove v Commissioner of Internal Revenue*, 490 F2d 241, 242–43, 247–48 (2d Cir 1973) (taxpayer wins); *Carrington v Commissioner of Internal Revenue*, 476 F2d 704, 705–06, 709 (5th Cir 1973) (taxpayer wins); *Rauenhorst v Commissioner of Internal Revenue*, 119 Tax Ct 157, 181 (2002) (taxpayer wins); *Palmer v Commissioner of Internal Revenue*, 62 Tax Ct 684, 693–95 (1974) (taxpayer wins).

161 Compare *Kornfeld v Commissioner of Internal Revenue*, 137 F3d 1231, 1233–36 (10th Cir 1998) (IRS wins); *Gordon v Commissioner of Internal Revenue*, 85 Tax Ct 309, 330–31 (1985) (IRS wins), with *Hansen Land v Commissioner of Internal Revenue*, 65 Tax Ct Mem Dec 2869, 2870–72, 2874 (1993) (taxpayer wins).

162 Compare *Wrenn v Commissioner of Internal Revenue*, 67 Tax Ct 576, 577–79, 582–83 (1976) (IRS wins), with *Vaughn v Commissioner of Internal Revenue*, 81 Tax Ct 893, 913–15, 917–18 (1983) (taxpayer wins); *Bowen v Commissioner of Internal Revenue*, 78 Tax Ct 55, 75–77, 81–86 (1982) (taxpayer wins).

163 Compare *Heintz v Commissioner of Internal Revenue*, 25 Tax Ct 132, 140–43 (1955) (IRS wins), with *Granite Trust v United States*, 238 F2d 670, 673–74, 678 (1st Cir 1956) (taxpayer wins).

164 I am not alone in concluding that the IRS has had mixed success in using judicial anti-abuse doctrines. See, for example, David A. Weisbach, *The Failure of Disclosure as an Approach to Tax Shelters*, 54 SMU L Rev 73, 77 (2001) ("For every case looking to substance over form or business purpose over tax motive, there is an equal and opposite case respecting a transaction that fits [the] description of [a] shelter[].").

165 See, for example, *American National Bank of Austin v United States (Bank of Austin II)*, 573 F2d 1201, 1202, 1207 (Ct Cl 1978); *Citizens National Bank of Waco v United States*, 551 F2d 832, 838, 843 (Ct Cl 1977); *Bank of California, NA v Commissioner of Internal Revenue*, 30 Bd Tax App 556, 559–61 (9th Cir 1934).

166 The economic substance doctrine is much less useful in this setting because it only attacks tax-motivated transactions that produce no meaningful change in a taxpayer's economic situation, apart from the receipt of tax benefits. See, for example, *ACM Partnership v Commissioner of Internal Revenue*, 157 F3d 231, 247 (3d Cir 1998) ("[W]e must look beyond the form of the transaction to determine whether it has the economic substance that its form represents, because regardless of its form, a transaction that is devoid of economic substance must be disregarded for tax purposes and cannot be the basis for a deductible loss.") (internal citations and quotation marks omitted). Transactions based on the tax-driven norms described above will pass this test easily. For example, whether hedge funds buy debt securities or lend to U.S. borrowers, they surely engage in a real activity. In other words, contractual norms do not negate formal contracts, they merely modify them. The even narrower sham transaction doctrine will clearly not apply as well.

> never regarded the simple expedient of drawing up papers as controlling for tax purposes when the objective economic realities are to the contrary.[167]

This language—sweeping as it is—surely loses some of its punch once we take into account that, among the twenty-six factors considered by the Court in deciding whether the form chosen by the taxpayer should be disregarded, only two involved informal understandings and contractual norms.[168] The rest dealt with the parties' legally enforceable rights and objective economic considerations. Similarly, a recent appellate decision that purported to "bypass appearances and focus instead on practical realities" decided against the taxpayer by relying solely on written contractual clauses that were buried in complicated documents and ignored by the lower court.[169] Thus, while courts often use the substance-over-form doctrine to disregard the "labels" placed by the parties on their transactions, they usually recharacterize these transactions based on legally enforceable rights and obligations arising from the very documents whose form they disregard.

Moreover, the facts-and-circumstances test used by courts to discern the substance of the transaction is highly open ended. In the words of a leading treatise, "it is almost impossible to distill useful generalizations from the welter of substance-over-form cases."[170] Especially where the informal arrangements become an issue, courts seem to pay particular attention to taxpayers' intent and purpose. In fact, one of the versions of the step transaction doctrine—the end result test—is explicitly intent based.[171] As a result, whether the transactions in question involve taxpayers and their controlled entities,[172] family

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167 *Frank Lyon Co v United States*, 435 US 561, 573 (1978) (quotation marks and citations omitted).

168 Id at 582–83 (referring to "the absence of any understanding between [the purported lessor and lessee that the lessee] would exercise any of the purchase options" and "the nonfamily and nonprivate nature of the entire transaction").

169 See *TIFD III-E v United States*, 459 F3d 220, 236–40 (2d Cir 2006) (concluding that the written provisions "show that the banks invested with reasonable expectations of repayment regardless of the success of the venture, and were not meaningfully at the risk of the business") (quotation marks omitted).

170 Bittker and Lokken, *Federal Taxation of Income, Estates and Gifts* at ¶ 4.3.3 (cited in note 86).

171 See, for example, *McDonald's Restaurants v Commissioner of Internal Revenue*, 688 F2d 520, 524 (7th Cir 1982) (stating that multiple transactions will be viewed as a single transaction for tax purposes when "they were really component parts of a single transaction *intended from the outset* to be taken for the purpose of reaching the ultimate result") (emphasis added); *King Enterprises, Inc v United States*, 418 F2d 511, 516 (Ct Cl 1969) (same).

172 See, for example, *True v United States*, 190 F3d 1165, 1180 (10th Cir 1999) (rejecting in part the lower court's summary judgment in favor of the IRS because the taxpayer's intent regarding transfers among his controlled companies was unclear).

members,[173] or contractual counterparties,[174] courts occasionally give credence to taxpayers' self-serving assertions regarding their motive and intent—assertions that are often impossible to verify.

To be sure, courts will find it easy to side with the government in the egregious cases. If the contractors wrote one thing, but expressly agreed on (and in fact did) something very different, and if this agreement is revealed in court, their actions may be attacked as fraudulent even if the undocumented agreement did not amount to an enforceable contract. The problem is that many cases will be ambiguous. For instance, not all foreign investors entering into equity swaps terminate them early. Even those who do may sometimes maintain their positions for the duration of the swap. Similarly, the confidentiality norm does not protect new tax minimization schemes forever. Eventually—and inevitably—someone defects. Moreover, precisely because parties rely on a contractual norm, they may well have no discussions about the norm-governed behavior, such as early swap terminations or the need to keep things confidential. All these facts will make the government's case more difficult.

This Article is not the place to undertake a detailed doctrinal analysis of conflicting judicial precedents. Rather, the point is that the current case law's treatment of informal arrangements is inconsistent and unclear. Factors such as the taxpayer's intent obfuscate the analysis and invite after-the-fact rationalizations. And certainly, there has been no reasoned judicial inquiry into how the general substance-over-form principle should be applied in the case of contractual norms.

The Internal Revenue Code addresses one social convention in great detail—the family commitment norm. The existing related party rules tax relatives as if they own assets they do not legally own,[175] control entities they have no legal right to control,[176] give away interests they actually sell,[177] and so on.[178] While the generalization underlying these rules sometimes proves to be desperately wrong, relatives are taxed as if they always act as loyal and loving family members,

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173 See, for example, *Vaughn*, 81 Tax Ct at 910 (explaining that the Tax Court established an "independent purpose test" for intrafamily installment sales).

174 See, for example, *Bank of Waco*, 551 F2d at 841 (upholding a transaction entered into "with no thought or purpose of tax evasion," even though when all was said and done the bank ended up lending funds to the taxpayer and receiving tax-exempt interest on that loan).

175 See 26 USC § 318(a)(1) (2006) ("An individual shall be considered as owning the stock owned . . . by or for his spouse . . . and [ ] his children, grandchildren, and parents.").

176 See 26 USC §§ 951(a)–(b), 958(b) (2006) (applying the attribution rule of § 318(a)(1) to determine ownership of a controlled foreign corporation).

177 See 26 USC § 704(e)(3) (2006) ("[A]n interest purchased by one member of a family from another shall be considered to be created by gift from the seller.").

178 See 26 USC § 267 (2006) ("No deduction shall be allowed in respect of any loss from the sale or exchange of property [between family members].").

whether they do so or not.[179] Unrelated parties relying on other contractual norms remain largely unimpeded by the Code.

In contrast with the tax statute, the Treasury regulations devote plenty of attention to informal practices. Unfortunately, one struggles in vain to find an overarching approach. Even the vocabulary is all over the map. The regulations repeatedly refer not just to contracts or agreements, but also to "understandings or arrangements"[180] that may be "written or oral,"[181] "formal or informal,"[182] "express or implied,"[183] "implicit or explicit,"[184] whether or not they are "legally binding on the taxpayer."[185] Do all these terms mean different things? Is there a reason they appear in some provisions but not in others?

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179 See, for example, Boris I. Bittker and James S. Eustice, *Federal Income Taxation of Corporations and Shareholders* ¶ 9.02[2] (Warren, Gorham & Lamont 7th ed 2006) (stating that there is no hostility exception to family attribution rules).

180 See, for example, Treas Reg § 1.355-7(h)(1)(i) (defining "agreement, understanding, or arrangement" for purposes of certain corporate distributions made in connection with acquisitions); Treas Reg § 1.170A-5(a)(4) (including within the meaning of future interests "situations in which a donor purports to give tangible personal property to a charitable organization, but has an understanding, arrangement, agreement, etc., whether written or oral ... which has the effect of reserving to, or retaining in, such a donor a right to the use, possession, or enjoyment of the property").

181 See, for example, Treas Reg § 1.170A-5(a)(4) (referring to "written or oral" agreements); Treas Reg § 1.483-1(a)(1) ("Section 483 may apply to a contract whether the contract is express (written or oral) or implied."); Treas Reg § 1.1271-1(a)(1) ("An intention to call a debt instrument before maturity means a written or oral agreement ... that the debt issuer will redeem the debt before maturity.").

182 See, for example, Treas Reg § 1.382-3(a)(1)(i) ("An entity includes a group of persons who have a formal or informal understanding among themselves to make a coordinated stock acquisition.").

183 See, for example, Treas Reg § 1.483-1(a)(1) ("Section 483 may apply to a contract whether the contract is express (written or oral) or implied."); Treas Reg § 1.957-1(b)(2) (stating that the voting power of U.S. shareholders in controlled foreign corporations will be determined by reference to "any agreement, whether express or implied, that the shareholder will not vote his stock or will vote it only in a specified manner"); Treas Reg § 20.2036-1(a)(ii) ("An interest or right is treated as having been retained or reserved if at the time of the transfer there was an understanding, express, or implied, that the interest or right would later be conferred."); Treas Reg § 301.6111-2(c)(1) (treating any offer as made "under conditions of confidentiality" if the offeree's ability to disclose the offer is limited "in any manner by an express or implied understanding or agreement").

184 See, for example, Treas Reg § 1.355-7(h)(1)(i)(A) (stating that agreements reached by third parties with "the implicit or explicit permission of" persons who control corporations involved in a spin-off that is followed by an acquisition of one of these companies shall be treated as agreements reached by such persons).

185 See, for example, Treas Reg § 1.6011-4(b)(3)(ii) ("A transaction is treated as confidential even if the conditions of confidentiality are not legally binding on the taxpayer."). See also Treas Reg § 1.1271-1(a) ("An intention to call before maturity can exist even if the intention is conditional ... or is not legally binding.").

No one really knows. The government has invoked these provisions in litigation on very few occasions.[186] Virtually no formal or informal IRS guidance considers their scope. The Treasury's attempt to specify when it will treat certain corporate restructurings as taking place pursuant to a formal or informal plan[187] has produced several sets of lengthy, transaction-specific, and increasingly taxpayer-favorable regulations that have been called "a parody" and "the Matrix."[188] The government clearly believes that taxpayers often rely on legally unenforceable promises and understandings—whether unique to a particular relationship or applicable in a given norm environment. Moreover, the government apparently realizes that this reliance is often motivated by tax considerations. What the government lacks is a coherent approach to the problem.

Should it respond to taxpayers' use of oral, informal, implicit, implied, and not legally binding understandings? How should it target the response? And how can it find these "invisible" practices? To answer these questions, we should first pinpoint what exactly is the problem with tacit understandings, at least as long as they are limited to contractual norms.

IV. THE COST OF NORMS

A. What Are the Costs?

The social norms literature has identified many social benefits of social norms. The tax inquiry highlights their social costs. Tax-driven contractual norms are a form of tax planning or, worse yet, tax shelters.[189] Both are undesirable for familiar reasons.

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186 See, for example, *Koehring Co v United States*, 583 F2d 313, 316–17 (7th Cir 1978) (finding existence of an implied agreement between U.S. and foreign co-owners of a joint company when the foreign party's directors referred to their participation as "nominal" in the minutes of the Board of Directors meeting); *Guynn v United States*, 437 F2d 1148, 1150 (4th Cir 1971) (taking account of informal arrangements to determine which taxpayer had "possession and enjoyment" of a house). "Possession and enjoyment" is a tax construct that courts may interpret by considering extrinsic evidence under *Estate of Craft*, 68 Tax Ct at 263.

187 More precisely, when the events occur pursuant to a "plan (or series of related transactions)." 26 USC § 355(e)(2)(A)(ii) (2006).

188 See Joseph M. Calliano, *The Matrix: Proposed Regulations Provide Insight on "Plan or Series of Related Transaction" in Section 355(e)*, 10 J Intl Tax 18 (2000); Robert A. Rizzi, *The Proposed Section 355(e) Regulations: A Parody*, 27 J Corp Tax 131 (2000).

189 Commentators disagree about the merits of the tax planning/tax shelter distinction, and no uniformly accepted definition of a tax shelter exists. Compare David A. Weisbach, *Ten Truths about Tax Shelters*, 55 Tax L Rev 215, 224 (2002) ("There is nothing in this analysis to distinguish shelters from all other planning."), with Michael L. Schler, *Ten More Truths about Tax Shelters: The Problem, Possible Solutions, and a Reply to Professor Weisbach*, 55 Tax L Rev 325, 384 (2002) ("[T]ax planning is not all bad."). However, the three most characteristic traits of a tax shelter are tax benefits, tax motivation (both typical of all tax planning), and inconsistency with congres-

In general, tax planning is inefficient because tax-motivated changes in behavior produce deadweight losses.[190] Taxpayers react to taxes, for instance, by working less than they would have preferred, accepting in-kind fringe benefits when they would have liked to receive cash, or paying tax shelter promoters and engaging in elaborate schemes whose only purpose is tax avoidance. These taxpayers incur costs, but no additional revenue is collected, so no one else benefits. This is a basic deadweight loss of tax planning.[191]

To the extent that tax planners are randomly dispersed throughout the economy, their actions are not reflected in the price system.[192] These planners simply reduce their share of the overall tax burden. Assuming the government needs to collect a fixed total revenue,[193]

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sional intent. See, for example, Joseph Bankman, *The Tax Shelter Problem*, 57 Natl Tax J 925, 925 (2004) (defining a tax shelter as "a (1) tax motivated; (2) transaction unrelated to a taxpayer's normal business operations; that (3) under a literal reading of some relevant tax authority; (4) produces a loss for tax purposes in excess of any economic loss; (5) in a manner inconsistent with legislative intent or purpose"); Schler, 55 Tax L Rev at 331 (defining a tax shelter as a transaction that "(1) arguably complies as a literal matter with the Code and regulations, (2) is accompanied by some level of tax motivation, and (3) reaches a tax result unintended by Congress or the regulations"). Tax-driven norms could not have possibly been part of the legislative design.

190 See, for example, Weisbach, 55 Tax L Rev at 222 (cited in note 189) (stating that "[t]ax planning is . . . almost always positively bad for society"). To be sure, sometimes these behavioral responses are exactly what Congress intended when it enacted a particular tax preference. Even these changes are not necessarily efficient, however. A congressional decision to subsidize or penalize a certain activity may have nothing to do with maximizing social welfare. Even when it does, taxpayers may overreact and change behavior (much) more than Congress intended. Besides, it is often unclear whether a particular tax provision is an intentional subsidy or an imperfect rule reluctantly adopted in light of administrability constraints. See id at 225 n 22 (suggesting that Congress should explicitly specify statutory provisions intended as subsidies). Not surprisingly, these so-called tax expenditures are generally viewed as inefficient. See, for example, Louis Kaplow, *How Tax Complexity and Enforcement Affect the Equity and Efficiency of the Income Tax*, 49 Natl Tax J 135, 143 (1996) (arguing that tax expenditures create distortions that lead to significant deadweight loss).

191 The government responds to tax planning with audits, litigation, and, in egregious cases, incarceration, incurring further costs. Taxpayers pay legal fees and waste more time defending their schemes. All of these costs are well-understood additional components of the basic deadweight loss of tax planning. See, for example, Daniel N. Shaviro, *Commentary: Evaluating the Social Costs of Corporate Tax Shelters*, 55 Tax L Rev 445, 446 (2001).

192 See Weisbach, 55 Tax L Rev at 223 (cited in note 189).

193 Constant total revenue is a standard assumption in tax policy literature. See, for example, id; Kaplow, 49 Natl Tax J at 148 n 6 (cited in note 190); Daniel N. Shaviro, *An Efficiency Analysis of Realization and Recognition Rules under the Federal Income Tax*, 48 Tax L Rev 1, 24 (1992). This assumption makes sense for two reasons. First, it allows "apples to apples" comparisons. Otherwise, a system with lower total income tax burden will always be more likely to have a lower total cost given that any income tax imposes a deadweight loss. Second, if we assume, instead, that lower taxes paid by some taxpayers reduce total revenues (that is, that the government does not compensate by collecting more taxes from others), the corresponding reduction in government spending produces a different welfare loss as long as the government programs being cut were welfare enhancing. In fact, if the government expenditures are optimal, the marginal cost of tax revenue is equal to the marginal benefit of tax expenditures. In this case, the

someone else must pay the extra tax. This shifting of the tax burden is very similar to a negative externality, and for the remainder of this Article I will treat it as such.[194] The externality adversely affects compliant taxpayers who engage in no tax planning, violating our distributive preferences.[195] The resulting equity cost may be expressed as a reduction in the social welfare function on account of socially undesirable redistribution of the overall tax burden.[196]

If tax planning is concentrated in a particular industry or group of taxpayers, the general equilibrium effects must be considered.[197] Taxpayers will flock to activities and groups that are subject to lower tax rates, producing an inefficient reallocation of resources and additional deadweight losses.[198] In a long-run equilibrium, this inefficiency will completely displace the inequity described in the preceding paragraph. Otherwise, tax planning will produce some of both.[199] Besides, even in a long-run equilibrium some honest/irrational members of the low-taxed group will eschew tax planning. They will end up paying an unfairly large amount of tax.[200]

Tax-driven norms present all of these problems. Taxpayers rely on them only reluctantly—they would prefer to formalize their tacit understandings, if not for the adverse tax consequences. Furthermore,

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welfare cost of a marginal tax increase and a marginal spending cut is exactly the same. See Kaplow, 49 Natl Tax J at 148 n 6.

194 The only difference is that an externality directly affects others while tax shifting has the same result by virtue of the government's actions, that is, the offsetting tax increase. See Weisbach, 55 Tax L Rev at 223 n 19 (cited in note 189).

195 The underlying assumption is that these preferences were satisfied in a system without tax planning. See Kaplow, 49 Natl Tax J at 145 (cited in note 190).

196 Id. This tax shifting is also unfair, almost certainly highly regressive (sophisticated tax advice is available only to the wealthiest taxpayers), and undermines our system of largely voluntary tax compliance. The discussion in the text is limited to efficiency considerations in part to facilitate the comparison of various costs, and in part because the full adverse effects of tax planning have been discussed at length elsewhere. See generally, for example, Joel Slemrod and Shlomo Yitzhaki, *Tax Avoidance, Evasion, and Administration*, in Alan J. Auerbach and Martin Feldstein, eds, 3 *Handbook of Public Economics* 1423 (Elsevier 2002) (presenting an overview of theoretical models and empirical data on tax avoidance and evasion).

197 See Shaviro, 55 Tax L Rev at 451–53 (cited in note 191); Kaplow, 49 Natl Tax J at 142–43, 145–46 (cited in note 190).

198 See Kaplow, 49 Natl Tax J at 146 (cited in note 190). Note that where a particular group lowers its members' tax rates by developing contractual norms, the resulting reallocation of resources is likely to be less inefficient than where the group's tax advantage has some other cause, such as a statutory preference. Generally, norms weaken as the number of their followers grows. For a formal model, see generally Robert Cooter and Janet T. Landa, *Personal versus Impersonal Trade: The Size of Trading Groups and Contract Law*, 4 Intl Rev L & Econ 15 (1984). The weaker the norm, the less effective it is in reducing taxes. Thus, as taxpayers rush to join a group that has developed especially effective tax-reducing norms, not only does the increased competition among taxpayers dissipate the rents previously earned by the (relatively few) group members, but the source of these rents (the tax-reducing norms) disappears at the same time.

199 Kaplow, 49 Natl Tax J at 142 (cited in note 190).

200 Id at 146.

tax-driven norms affect groups of taxpayers; thus we should expect general equilibrium effects. If, for instance, offshore hedge funds may lend to U.S. borrowers tax free, while commercial banks must pay tax on profits from their U.S. lending business, we should expect too much lending by hedge funds. In addition, the relevant prices are unlikely to adjust fully. If nothing else, barriers to entry (a common feature of norm environments[201]) assure that elasticity of substitution between high-tax and low-tax groups is far from infinite in this context. Thus, hedge fund investors will benefit from an unfair tax break. In sum, tax-driven norms are both inefficient and inequitable. Reducing their use where doing so is not particularly costly will improve social welfare.

The cost of tax-relevant norms is smaller than the cost of tax-driven ones. By definition, tax-relevant norms do not exist for tax reasons—their tax effects are unintentional. Therefore, they do not give rise to the basic deadweight loss of tax planning. They do, however, result in tax shifting. Some norms, like the repo norm (and the non-contractual neighborliness norm), *reduce* the taxes of the cooperative taxpayers relying on them. Like tax-driven norms, these norms produce an inefficient tax externality and an allocative distortion.[202]

The tax-relevant norms that, like the CDS norm, *increase* the tax liabilities of the group members also result in tax shifting. Perhaps counterintuitively, this is inefficient as well. Whether the members of a norm environment externalize or internalize the extra tax—that is, whether they or the outsiders pay "too much"—economic activity will adjust to take either distortion into account. The difference between tax-externalizing and tax-internalizing tax-relevant norms is on the equity side. Especially where tax-internalizing norms involve relatively sophisticated taxpayers, one can hardly complain that these norms are unfair. If the CDS market participants are unhappy about the weaker tax positions resulting from poor documentation practices, they should just fix their bookkeeping.[203]

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201 See, for example, Richman, 31 L & Soc Inquiry at 388, 404, 412 (cited in note 11) (discussing separate barriers to entry in the diamond industry in the U.S. and in Israel); Bernstein, 99 Mich L Rev at 1788 n 237 (cited in note 10) (arguing that "an industry's decision to rely on reputation-based nonlegal sanctions does create some barriers to entry").

202 Of course, these norms may (and probably do) have other welfare-*increasing* consequences. My point here is not that these norms are inefficient overall, but merely that their tax-externalizing feature is inefficient. For an example of how apparently equally inefficient tax shelters may have different total welfare costs, see Shaviro, 55 Tax L Rev at 452–53 (cited in note 191). In addition, as the repo example amply demonstrates, tax-externalizing tax-relevant norms give rise to audits and litigation, adding to the enforcement costs.

203 Not surprisingly, they are doing just that. See Raisler and Teigland-Hunt, 25 Intl Fin L Rev at 44–45 (cited in note 105).

While it is conceivable that there are as many tax-internalizing tax-relevant norms as tax-externalizing ones, some healthy skepticism is warranted. I suspect that it was no accident that the repo norm produced a clear tax benefit while the CDS norm only arguably led to a potential (but fairly unlikely) tax increase. Rational contractors may be expected to be particularly attentive to contractual norms that raise their taxes, especially if the increase is certain and large. In other words, while they did not adopt a particular norm for tax reasons, they are much more likely to abandon it (sooner) if the norm is tax internalizing. Therefore, until future research suggests otherwise, it appears reasonable to assume that most tax-relevant norms *decrease* the tax burden of taxpayers relying on them, externalizing some of their tax liabilities. They are not as inefficient as the tax-driven norms, but they are inefficient nonetheless. Both types are inequitable.

B. Costly Norms: Predictions Confirmed

This analysis should come as no surprise to the social norms scholars. In fact, they predicted socially costly norms long ago. Racial segregation norms in the Jim Crow South and the "law" of Mafia loyalty are familiar examples.[204] Even in a purely commercial context one has to grapple with the key role of unenforceable agreements in the formation and maintenance of illegal cartels.[205]

Norms holding together cartels (as well as Mafia clans) deliberately and unambiguously violate clear legal rules.[206] Would limiting the inquiry to the economic sphere and excluding the norms that underlie plainly illegal activities eliminate concerns with inefficient social norms? Not necessarily. Commentators have warned that the same familiar forces that cause the market's generally efficient invisible hand to fail once in a while may also produce inefficient social norms. Monopolies, information asymmetries, strategic behavior, and externalities are the usual culprits.[207] Not only are these unfortunate draw-

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204 See, for example, Ellickson, *Order without Law* at 169 (cited in note 4).

205 See, for example, Eric A. Posner, *Law, Economics, and Inefficient Norms*, 144 U Pa L Rev 1697, 1722 (1996).

206 At least this is true of "smoke-filled backroom discussions, where titans of industry set prices over cigars and whiskey." Dean Harvey, Comment, *Anticompetitive Social Norms as Antitrust Violations*, 94 Cal L Rev 769, 769 (2006). An explicit agreement to form and maintain a cartel gives rise to a commercial norm because the rules established by the cartel members are not legally enforceable.

207 See, for example, Robert D. Cooter, *Decentralized Law for a Complex Economy: The Structural Approach to Adjudicating the New Law Merchant*, 144 U Pa L Rev 1643, 1655, 1684 (1996) (warning about incentive structures capable of producing inefficient norms, spillovers, and exploitation); Avery W. Katz, *Taking Private Ordering Seriously*, 144 U Pa L Rev 1745, 1749 (1996) (observing that "private groups and communities are subject to the same kinds of failures

backs possible, they should be expected. Ellickson went so far as to argue that it would be strange if "close-knit" groups did not try to externalize some of their costs.[208] The idea that norms efficient at a group level may be wasteful for society as a whole has been well understood for some time.[209]

Despite these theoretical concerns, concrete examples of modern, pervasive, and socially harmful commercial norms are rare.[210] Only the most recent work has begun to highlight commercial norms that produce antitrust violations even in the absence of express price-fixing agreements.[211] One of the most vivid instances of a group norm imposing a negative externality comes from Ellickson's own book. Following a detailed description of the remarkably flexible and efficient (at a group level) norms developed by the American whalers in the late nineteenth century, Ellickson acknowledges that these norms made the whalers so effective that the whales they hunted ended up on the brink of extinction.[212] Society as a whole bore a significant cost.

The examples of inefficient commercial norms pale in comparison to the extensive and detailed analysis of their welfare-enhancing counterparts.[213] At the same time, while several theories have been

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as are market and governmental institutions"); Posner, 144 U Pa L Rev at 1698, 1711–13, 1722–25 (cited in note 205) (discussing information asymmetries and strategic behavior leading to development of inefficient norms); Deakin, Lane, and Wilkinson, 21 J L & Socy at 343 (cited in note 28) (discussing the possibility of economic exploitation arising out of "contractual environments"); Ellickson, *Order without Law* at 181 (cited in note 4) (arguing that "'social imperfections' [are] analogous to the 'market imperfections' identified in traditional economic theory").

208 Ellickson, *Order without Law* at 258 (cited in note 4) ("From the members' perspective, a failure to exploit an opportunity for externalization is a deadweight loss."). See also Posner, 144 U Pa L Rev at 1723 (cited in note 205) ("Groups have a stronger incentive to adopt or develop norms that externalize costs than those that merely maximize joint welfare without producing negative externalities.").

209 See, for example, Richard A. Posner, *Social Norms and the Law: An Economic Approach*, 87 Am Econ Rev 365, 366 (1997) ("Even if norms tend to be efficient within the group . . . they may be bad for society as a whole.").

210 In his argument that norms are likely to be inefficient, Eric Posner's case in point was a hypothetical failure of the insurance market caused by the family norms of mutual support. The example was borrowed from a theoretical model offered by two economists, not from any real life observations. See Posner, 144 U Pa L Rev at 1722 (cited in note 205). In addition, Lisa Bernstein acknowledged that a private legal system created by the U.S. cotton industry may potentially create antitrust problems and deny its members procedural protection. See Bernstein, 99 Mich L Rev at 1788 n 238 (cited in note 10). These problems never materialized, however, because of the background presence of antitrust and state arbitration laws containing procedural safeguards. See id ("Although, at present, industry-run PLSs do not, standing alone, create antitrust problems, the availability of the antitrust laws to ensure that the associations do not engage in anticompetitive behavior may be important.").

211 See Harvey, Comment, 94 Cal L Rev at 782–84 (cited in note 206).

212 See Ellickson, *Order without Law* at 206 (cited in note 4) ("The whaling saga is thus a reminder that norms that enrich one group's members may impoverish, to a greater extent, those outside the group.").

213 See text accompanying notes 20–32.

offered to explain the prevalence of social norms,[214] no one has developed a robust mechanism of predicting norms' content or whether a particular norm will be efficient.[215] Without tools to forecast the emergence of inefficient norms, and in the absence of strong empirical evidence of their existence, the prevailing tenor of the social norms scholarship has remained decidedly positive.[216]

The discussion of tax-relevant and especially tax-driven norms arms the skeptics with a powerful new example. By relying on unstated yet binding rules of behavior, taxpayers often reduce their tax liabilities. This tax reduction may be the result of a deliberate strategy or mere happenstance. In either case, assuming the government needs to collect a fixed total revenue, someone else must pay the extra tax.

Thus, just as the norms scholars predicted, social norms impose an externality. Groups with strong informal norms may (and do) externalize a portion of their members' tax burden to the outsiders, gaining an unfair advantage and producing economic distortions. In addition, those who rely on tax-driven norms incur the basic deadweight loss of tax planning. The combination of these efficiency and equity costs is the full tax-related cost of norms.

V. REDUCING THE SOCIAL COST OF CONTRACTUAL NORMS

A. Choosing the Approach

It is tempting to start evaluating various responses to costly contractual norms by immediately proceeding to their cost-benefit analysis. Tempting, but wrong. We cannot decide how the government should deal with these norms while ignoring alternative reforms.

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214 See Ellickson, *Order without Law* at 149–55, 167–83 (cited in note 4) (describing several theories and advancing his own theory of welfare-maximizing norms). See also Posner, *Law and Social Norms* at 18–27 (cited in note 23) (signaling theory); McAdams, 96 Mich L Rev at 355–76 (cited in note 19) (esteem theory); Jody S. Kraus, *Legal Design and the Evolution of Commercial Norms*, 26 J Legal Stud 377 (1997) (evolutionary theory); Cooter, 144 U Pa L Rev at 1661–77 (cited in note 207) (internalization theory).

215 See, for example, McAdams, 96 Mich L Rev at 424 (cited in note 19) (concluding that "although esteem norms can be efficient, there is no reason to think, on average, that they are"); Posner, 144 U Pa L Rev at 1719 (cited in note 205) ("Good norms depend on luck."); Ellickson, *Order without Law* at 153 (noting that interest group norm theories "say little about when and how an interest group can control the content of norms"), 167–70 (cited in note 4) (predicting that members of close-knit groups develop welfare-maximizing norms for their workaday affairs, but admitting that some of these norms may be harmful to society as a whole). But see generally Amitai Aviram, *A Paradox of Spontaneous Formation: The Evolution of Private Legal Systems*, 22 Yale L & Policy Rev 1 (2004) (offering a mechanism of norm creation).

216 See, for example, Posner, *Law and Social Norms* at 171 (cited in note 23) ("[M]any economists and law professors find that social norms solve strategic dilemmas that would otherwise reduce overall well-being."); McAdams, 96 Mich L Rev at 409 (cited in note 19) (listing theorists optimistic about the efficiency of norms).

The existence of norm-based tax planning may mean, for instance, that the substantive tax rules are insufficiently precise, failing to correctly define the relevant "transaction" to include its informal components and, therefore, failing to capture the true economic income of taxpayers who rely on contractual norms. But, of course, the tax law suffers from many other imperfections. Fundamental tax concepts such as ownership,[217] time value of money,[218] and risk[219] remain uncertain. It is not at all clear why Congress should focus on the imprecise doctrinal treatment of social norms.

Alternatively, the problem may be lack of enforcement.[220] Perhaps, if the government introduced stiffer penalties for norm-based tax avoidance or made it the focus of auditors' attention, this type of tax avoidance would become less popular. Again, however, plenty of other candidates suggest themselves. For instance, the government may devote its limited enforcement resources to collecting known tax liabilities[221] or reducing taxpayers' incentives to hide their aggressive transactions.[222] How should the government choose?

One promising strategy is to estimate the marginal efficiency cost of funds (MECF) of various measures.[223] The MECF approach measures the social cost of any incremental reform designed to collect additional tax revenue indirectly, by comparing the projected and actual revenue raised by it. While the calculations required by the MECF model are not out of the realm of possibility,[224] the marginal efficiency costs of various alternatives are yet to be measured and the precision

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217 See, for example, Raskolnikov, 85 BU L Rev at 431 (cited in note 64) (arguing that the concept of ownership in the tax law remains "remarkably confused").

218 See, for example, David A. Weisbach, *Reconsidering the Accrual of Interest Income*, 78 Taxes 36, 36–39 (2000) (addressing inconsistencies in the tax law's treatment of different types of interest).

219 See, for example, Daniel Shaviro, *Risk-Based Rules and the Taxation of Capital Income*, 50 Tax L Rev 643, 644 (1995) (questioning whether the existing risk-based rules can assure taxation of capital income).

220 See Kaplow, 49 Natl Tax J at 143 (cited in note 190) ("[T]he equity and efficiency analysis of the accuracy of tax administration is quite similar in structure to that of complexity and compliance costs.").

221 See, for example, Joel Slemrod and Jon Bakija, *Taxing Ourselves: A Citizen's Guide to the Debate over Taxes* 185 (MIT Press 3d ed 2004) (discussing the government's disappointing record in collecting known tax liabilities).

222 See, for example, Alex Raskolnikov, *Crime and Punishment in Taxation: Deceit, Deterrence, and the Self-Adjusting Penalty*, 106 Colum L Rev 569, 587–94 (2006) (discussing the existing incentives to conceal aggressive tax positions).

223 See Joel Slemrod and Shlomo Yitzhaki, *The Costs of Taxation and the Marginal Efficiency Cost of Funds*, 43 IMF Staff Papers 172, 183–89 (1996) (arguing that an analysis of the MECF of various revenue-raising measures "can evaluate marginal changes in tax systems").

224 See, for example, Weisbach, 55 Tax L Rev at 241–42 (cited in note 189) (noting that the data needed to measure MECF are "routinely gathered for tax law changes"); Daniel N. Shaviro, *Economic Substance, Corporate Tax Shelters, and the Compaq Case*, 88 Tax Notes 221, 237–38 (2000) (referring to the MECF method as "surprisingly practical").

of any such measurement is yet to be estimated. For now, the MECF method remains a model, albeit a promising one.[225]

The analysis behind this model, however, can be applied more broadly. It shows that responding to a particular phenomenon (such as tax-driven norms) simply because the response would produce additional revenue is misguided, as is choosing among various incremental tax reforms by comparing the expected revenues they would produce.[226] Nor is it appropriate to balance these revenues against the administrative costs incurred by the government in raising them—another common mistake.[227] Instead, for each alternative reform, we should compare the expected revenue to the full social cost of raising it. To estimate this cost (other than by deploying the MECF approach), we would need to identify and evaluate all of its components.

We can now consider whether, and in what circumstances, the government should attempt to reduce the tax cost of contractual norms. Whether the problem is rule inaccuracy or underenforcement, the government's attack on these norms will give rise to some typical and well-understood costs. For instance, if the government issues new rules that make norm-based tax planning more difficult, some taxpayers will redouble their effort to avoid the strengthened rules, wasting even more resources.[228] Similarly, if Congress increases penalties for norm-based tax avoidance, taxpayers will incur risk-bearing deadweight losses because, among other things, enforcement is imperfect and innocent individuals may be forced to pay the higher fines.[229] These costs are common, however. They will also arise if the government tightens the corporate reorganization provisions, raises the tax shelter reporting penalties, or proceeds with any other effort intended to increase tax collections.

The relevant question, then, is not what costs will be incurred if the government takes action against norm-based tax planning. Rather, we should consider whether such action will give rise to any *unique*

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225 See Heidi Glenn, *Dynamic Scoring a Distant Goal, Panelists Say*, 111 Tax Notes 1472, 1472–73 (2006) (describing experts' diverging views regarding the likelihood of widespread use of dynamic scoring—a technique similar to that needed for MECF calculations—in analyzing tax bills).

226 Both of these metrics fail to take costs into account.

227 See, for example, Slemrod and Yitzhaki, *Tax Avoidance, Evasion, and Administration* at 1451 (cited in note 196) (arguing that the "social cost [of tax enforcement expenditures] is not well measured by the increased revenue"); Kaplow, 49 Natl Tax J at 144 (cited in note 190) ("[T]he proper cost-benefit analysis does not simply compare the enforcement cost to the revenue raised.").

228 See Kaplow, 49 Natl Tax J at 146 (cited in note 190) ("When enforcement is increased but still not wholly effective, individuals may devote more resources to hiding income.").

229 See, for example, A. Mitchell Polinsky and Steven Shavell, *The Optimal Tradeoff between the Probability and Magnitude of Fines*, 69 Am Econ Rev 880, 880 (1979).

costs, and whether these costs are likely to vary among different types of contractual norms. These questions are considered next.[230]

B. Taxing Tax-Driven Contractual Norms

If the government could wave a magic wand and identify all tax-driven norms, its next step would be quite uncontroversial. By definition, these norms reflect unstated agreements that taxpayers would prefer to include in their written contracts. Instead, they keep these agreements informal to achieve favorable tax outcomes. Inefficiency and inequity result. If the government starts taxing tax-driven norms—that is, treats them as legally enforceable contractual terms for tax purposes—the only reason for keeping these norms out of contracts will disappear, and with it, the social costs of tax-driven contractual norms. Trouble is, the government has no magic wand. Attacking tax-driven norms would be feasible only if they can be identified at a reasonable cost. More than one obstacle is likely to arise.

1. Establishing intent.

The tax law has struggled mightily with discerning purpose, motive, and intent. The economic substance doctrine and at least one version of the step transaction test require courts to make these determinations.[231] Without a mindreading machine, courts discern intent and

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230 A related approach is to assess the efficiency of a given reform by considering whether it is likely to reduce the elasticity of taxable income, and, if so, at what cost. See generally David A. Weisbach, *An Economic Analysis of Anti-Tax-Avoidance Doctrines*, 4 Am Law & Econ Rev 88 (2002). The most important factor is whether most taxpayers will respond to a reform by engaging in an even more inefficient behavior or will abandon their tax-motivated transactions instead. In some cases, it is fairly clear what the more inefficient alternative is and what is the cost for those taxpayers who decide to forego tax planning attacked by the reform. For instance, if taxpayers are no longer able to sell their appreciated assets without triggering taxable gain by entering into perfect hedges, some taxpayers will shift to somewhat less complete hedges, incurring additional tax planning costs and risk-bearing losses. Others will keep their securities unhedged, increasing the lock-in effect. See David A. Weisbach, *An Efficiency Analysis of Line Drawing in the Tax Law*, 24 J Leg Stud 71, 81–82 (2000). This type of analysis is simply unavailable for contractual norms because norm-based tax avoidance has not been studied. Thus, we need to begin by asking what *are* the possible taxpayer responses to various reforms aimed at taxing contractual norms, and what are their respective social costs. This task is undertaken in the rest of this Article, and especially in Part V.C. Once these responses are identified, the information may be used in economic models to evaluate potential revenue that is likely to be raised by alternative measures and to compare the results with static revenue estimates. These comparisons, combined with estimates of the administrative costs of various proposals, would then be used to evaluate the change in taxable income elasticity or the marginal efficiency cost of funds raised by alternative reforms.

231 The subjective prong of the economic substance doctrine is focused entirely on taxpayers' personal motives and subjective expectations. See, for example, Joseph Bankman, *The Economic Substance Doctrine*, 74 S Cal L Rev 5, 26–27 (2000). For a discussion of the end result version of the step transaction test, see text accompanying note 171.

motive by looking to objective indicia such as contemporaneous documents, evidence of meetings, the significance of tax benefits, consistency with the overall business, and the like.[232] These inquiries produce considerable uncertainty. To complicate things further, the amount of nontax motivation that would be sufficient to exculpate the transaction remains unclear.[233] As a result, transactions that the Tax Court finds egregious enough to merit penalties end up being approved on appeal.[234]

Undeterred, Congress continues to scatter references to "the" (or "a") "principal" (or "significant") purpose of tax avoidance throughout the Code. Whether these generic statutory admonitions succeed in practice is another matter. It is revealing that a leading tax treatise remarks that the crown jewel of these provisions produced surprisingly few government victories early, and, despite some later success, is becoming less effective again.[235]

These difficulties, it should be highlighted, arise from attempting to discern and prove the motive or intent of a single individual (or a small group of individuals). To demonstrate the tax-driven character of a norm, the government would need to identify and verify the intent behind a customary practice. This would call for an inquiry into the intent of many (possibly most) of the individuals who follow it.

Undertaking this inquiry will be very difficult in any state of the world, but it will be next to impossible in our adversarial legal system. All but one (or very few) taxpayers whose intent is relevant will not be parties to a particular litigation (unless the IRS sues all of them at once in a kind of a reverse class action—a far-fetched proposition, to put it mildly). Even if the government solicits their explanations of a particular custom during audits, it will be often unable to introduce this evidence in its case against a single taxpayer who relied on that custom.[236] Numerous taxpayers may have all sorts of idiosyncratic rea-

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232 See, for example, Bankman, 74 S Cal L Rev at 27 (cited in note 231); David A. Weisbach, *Formalism in the Tax Law*, 66 U Chi L Rev 860, 881 (1999).

233 See Bankman, 74 S Cal L Rev at 17 (cited in note 231).

234 See, for example, *Compaq Computer Corp v Commissioner of Internal Revenue*, 277 F3d 778, 788 (5th Cir 2001).

235 See Bittker and Lokken, *Federal Taxation of Income, Estates and Gifts* at ¶ 95.4 (cited in note 86) (discussing 26 USC § 269, entitled "Acquisitions Made to Evade or Avoid Income Tax").

236 The government believes that exceptions from 26 USC § 6103 (2006) (the general prohibition on disclosure of taxpayer information) allow it to disclose tax information about an unrelated taxpayer who participated in a transaction substantially similar to the one involved in a given proceeding, but only if the transaction was sold by the same promoter. See *IRS Provides Guidance on Disclosure of Third-Party Tax Information in Tax Shelter Matters*, Tax Notes Today 210-25 (Nov 1, 2005) ("[This] information can be introduced . . . since it directly relates to a transactional relationship between [the promoter and investor in question] and directly affects the resolution of an issue in the injunction proceeding."). Unlike typical tax shelters, most contrac-

sons to follow a particular informal practice.[237] Whether these reasons are real or after-the-fact rationalizations, they may well appear fairly convincing when offered at least by some individuals. In sum, direct inquiries into subjective motivations of numerous taxpayers are unlikely to bring the government much success in dealing with tax-driven norms.[238]

2. Distinguishing acceptable tax avoidance.

The considerable difficulty with proving the intent behind tax-driven norms is not the only problem. Learned Hand's statement that "a man's motive to avoid taxation will not establish his liability if the transaction does not do so without it"[239] is as true today as it was when he made it. As long as the transaction is "real" (itself an ambiguous term), its tax consequences are usually unaffected even by a clearly established tax motivation.[240] Congress on numerous occasions responded to pure tax-reduction schemes not by eliminating the tax benefit involved, but by merely exacting a price from those who sought that benefit in the future.

For instance, some taxpayers took advantage of the realization requirement by selling their depreciated securities and immediately buying them back. Their only purpose was to realize the tax loss while keeping the security. Congress responded by disallowing the loss unless a taxpayer parted with the depreciated security for more than a

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tual norms are not "promoted" by a particular individual or entity, so the crucial link between a litigating taxpayer and other followers of the same tax-driven norm is missing. The government's position should be stronger, however, if it audits a financial intermediary that entered into numerous transactions with different taxpayers involving the same contractual norm.

237 For instance, practitioners report that some of their bank clients occasionally terminate equity swaps at the customer's request. These terminations are not tax motivated, and may involve no withholding issues at all (because the client is a U.S. taxpayer). To take another example, while the norm of leaving tips in restaurants (as well as cabs and other establishments) is not a contractual norm and is not discussed here in detail, it is a good example of diverging rationales behind a commercial norm. I was initially convinced that, while the reasons behind the tipping norm are generally unclear, customers who pay their bill with a credit card but leave the tip in cash do so to assist the waiter's tax avoidance. Others assured me, however, that this is exactly what they do with no thought about taxes. Some view cash tips as more personal. Some believe that cash tips are more likely to stay with the specific waiter rather than go into a common pool. Some are just used to leaving cash tips from the days when the entire bill was paid in cash.

238 In other words, the administrative cost of attacking only tax-driven norms is likely to be prohibitively high.

239 *Chisholm v Commissioner of Internal Revenue*, 79 F2d 14, 15 (2d Cir 1935).

240 Usually "real" means having a "practical economic effect." See, for example, *ACM Partnership v Commissioner of Internal Revenue*, 157 F3d 231, 248 (3d Cir 1998). Sometimes, an even less demanding standard is used. See, for example, *Cottage Savings v Commissioner of Internal Revenue*, 499 US 544 (1991) (upholding a transaction motivated solely by tax considerations and having no economic effect on taxpayer's holdings).

month.[241] In other words, as long as the taxpayer pays a price by waiting thirty-one days to reacquire identical security, she may engage in tax-motivated sales to her heart's content. The Code is full of provisions that operate in a similar fashion.[242]

Taxpayers who decide to rely on unenforceable norms rather than on legally binding contractual provisions pay a price as well. Just like the seller of a depreciated security who must bear a risk of adverse market moves while she counts till thirty-one, a taxpayer relying on informal custom takes a risk that her contractual partner will not act as expected. As long as (or, more precisely, to the extent that) the risk is real, why should it be ignored in the latter context, but not in the former?

Risks inherent in human interactions are very different from those arising in impersonal and objective financial markets. For contractual norms, these risks depend on the *strength* of a given norm and its *clarity*. The two are related but different in important respects.

The earlier examples of contractual norms suggest that these norms vary considerably in their strength. The repurchase norm in the repo market was very strong. As the repo decisions emphasized, norm violators faced certain expulsion from the market, leading to the inevitable loss of their business.[243] Similarly, United Shoe's practice of repairing its broken machines appears to have been a strong norm. Even though the company had a dominant market position, it felt compelled to conduct the repairs mostly at its own cost, and so did its competitors. The small number of insurance companies that underwrite the private placement debt market follow a strong norm of renegotiating strict debt covenants typically found in the private place-

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241 See 26 USC § 1091 (2006). This statement is a gross simplification. For a detailed discussion of the wash sale rules of § 1091, see David M. Schizer, *Scrubbing the Wash Sale Rules*, 82 Taxes 67, 67 (2004).

242 To take another example, the congressional response to tax-free hedging included a requirement that the hedge must be imperfect, that is, that taxpayers must retain some of the unwanted exposure to the asset being hedged. See 26 USC § 1259 (2006); Schizer, 101 Colum L Rev at 1362–67 (cited in note 63). Under this regime, whether a taxpayer enters into a VPF to defer recognition of gain on appreciated stock (a tax consideration) or because she likes the precise exposure resulting from combining her long stock with a short VPF (a nontax consideration), the tax treatment is the same. If the VPF provides for enough variation in the amount of stock delivered at maturity, she has no gain in either case; if it does not, she is taxable under § 1259 regardless of her underlying motivation.

243 Even a strong norm, however, will not be followed in an endgame. When one of the banks that lost in the repo litigation informed bond dealers that it would no longer participate in the repo market, only those dealers whose written calls were in the money exercised them. Holders of out of the money calls ignored the norm and refused to repurchase. See *American National Bank of Austin v United States (Bank of Austin II)*, 573 F2d 1201, 1205 (Ct Cl 1978).

ment indentures.[244] Borrowers often request renegotiation, and the lenders renegotiate in good faith most of the time.

On the other hand, the general counsel of various U.S. companies report that they would grant price relief to a customer or supplier following a shift in market prices only sometimes.[245] While 95 percent of respondents would not reject such a request out of hand, apparently there is no strong norm to actually accept a renegotiation. These attitudes are similar to the findings of a much earlier survey of Connecticut manufacturers who followed a practice of relying on their suppliers' oral confirmations. The norm was weak, though. The manufacturers relied on it somewhat more than half of the time, meaning that in many cases they did demand a written confirmation, violating the norm.[246] The norm's strength matters in the tax analysis because it reveals the level of risk assumed by a taxpayer relying on it. The weaker the norm, the larger the risk.

The same is true of vague norms. The repo norm is very clear: a repo'd security must be sold on either party's demand for the original purchase price plus agreed upon interest (unless the repo buyer retains the interest paid on the repo'd securities). A practice of accepting uncertified weights in direct contravention of written contractual terms is another example of a clear norm. Similarly, it appears that the loan origination norm among hedge funds and commercial banks is very clear: in the absence of material adverse changes, the funds must purchase loan tranches two days after origination for the same price they would have paid when the loan was made. And, of course, the confidentiality norm could not be clearer—do not disclose, period.

The implicit understanding that strict private placement debt covenants will be renegotiated in the future is an example of a vague norm. What exactly do the parties implicitly agree on when they follow it? They have a general understanding that they will try to work things out, but the outcome of this future renegotiation is highly uncertain.[247] Similarly, the widespread practice of renegotiating the con-

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244 Mark Carey, et al, *The Economics of the Private Placement Market*, 166 Staff Studies 4 (Board of Governors of the Federal Reserve System 1993), online at http://www.federalreserve.gov/pubs/staffstudies/1990-99/ss166.pdf (visited Apr 17, 2007):

> Covenants in information-intensive debt contracts are frequently violated, triggering renegotiations. [Because] a lender is in a position to extract considerable rents . . . [b]orrowers . . . prefer to contract initially only with lenders that have a reputation for fair dealing. This preference is especially strong in the private placement market.

245 See Weintraub, 1992 Wis L Rev at 18–19 (cited in note 16).

246 See Comment, 66 Yale L J at 1052–53 (cited in note 16).

247 No doubt, this is largely so because the parties do not have nearly enough information at the time the loan is made about future contingencies that would give rise to renegotiation. Notably, the understandable intuition that the most likely cause of such renegotiation must be a deterio-

tract price if market prices shift substantially is hardly clear.[248] If the market prices suddenly double, a change in the contract price equal to 1 percent, 50 percent (to split the difference), or 100 percent (to match the market move) would all satisfy this vague norm.

There is no necessary correlation between a norm's strength and its clarity. A norm among Connecticut manufacturers of not requesting a written acknowledgement from a supplier is clear but weak. A norm of renegotiating private placement debt covenants is vague but strong. Norms of both types expose the parties that depend on them to considerable risk. Needless to say, relying on norms that are weak and vague is even riskier. On the other hand, the repo norm and the custom of accepting uncertified weights are both clear and strong. Parties relying on these norms do not risk all that much by eschewing formalization.

The differences in the strength and clarity of contractual norms are hardly insignificant. Ignoring these differences would introduce serious arbitrariness into the tax law. No matter how obvious the intent behind a tax-driven norm is, if the norm is unclear or vague—that is, if it subjects taxpayers to a meaningful risk—the norm should not be treated as legally binding for tax purposes as long as the tax law continues to grant benefits to solely tax-motivated but real transactions. Determining clarity and specificity of a norm is difficult, however. Neither the IRS nor the courts have a lot of experience in making these evaluations. Yet an attack focused only on tax-driven norms must rely heavily on a precise assessment of their strength and clarity. An approach that places a lot of weight on a determination that is unlikely to be made with a high degree of accuracy leaves much to be desired.

C. Taxing All Contractual Norms

One way to solve the problem of identifying tax-driven norms is to adopt a solution that requires no such identification. Attacking all norms by treating them as binding contractual provisions would fit the bill. (The intermediate choice of attacking tax-driven and tax-relevant norms raises most of the problems discussed below[249] and will not be considered separately.) In addition to eliminating the need to discover and prove an intent behind a custom, this approach is attractive in its neutrality.

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ration in the financial condition of the borrower turns out to be mistaken. Carey, et al, 166 Staff Studies at 14 n 32 (cited in note 244) ("[R]oughly half of a sample of private placements were modified at least once; most modifications occurred while the loans were in good standing.").

248 See, for example, Weintraub, 1992 Wis L Rev at 18–19 (cited in note 16); Victor P. Goldberg and John R. Erickson, *Quantity and Price Adjustment in Long-Term Contracts: A Case Study of Petroleum Coke*, 30 J L & Econ 369, 390 (1987) (describing the "good faith" requirement of both contractually mandated and norm-based renegotiations of contract prices following a substantial change in the petroleum coke market).

249 See text accompanying notes 256–81.

Contractual norms, after all, are an essential part of doing business, just as formal contracts are. No doubt, some (parts) of these contracts are motivated by tax considerations. Others are not, however, because the parties simply forgot to consider the tax consequences, ignored them because other factors were critically important, or concluded that no tax consequences would arise at all. Generally, the tax law does not inquire into these matters. The same tax rules apply to all contracts, tax motivated or not.[250] Why should the approach differ for contractual norms? Why not adopt the same tax regime for all of them—tax driven, tax relevant, and tax neutral alike?

At least from the social welfare standpoint, the answer hinges on the relative costs of doing so. These costs depend on the likely behavioral responses to a new law (or regulation) stating that the government will determine the tax consequences of any written contract by taking into account the related informal customary practices. Given the amount of uncertainty that will follow this doctrinal development, some response is all but assured.

1. The new uncertainty.

As soon as the government attacks all contractual norms, taxpayers relying on them will face several new questions. First, what is the precise content of the norm (or norms) they use? Second, how will the government interpret this norm? Third, what would the tax consequences be if the norm were treated as legally enforceable?

None of these questions will necessarily have a simple answer. Identifying the norm that taxpayers rely on will be easy if the norm is strong and clear. Predicting the government's view of this norm will not be difficult either. As we have seen from the admittedly limited set of examples, however, it is quite unlikely that most (or even many) norms will score high in both categories. If the norm is weak or vague, those relying on it will have work to do.

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250 Of course, there are exceptions from the general rule. See, for example, 26 USC § 269 (denying tax benefits based on a taxpayer's intent behind acquisitions of corporate control); 26 USC § 357(b) (2006) (denying generally favorable tax treatment of liability assumptions if the principal purpose behind the assumption is tax avoidance). Intent- and purpose-based exceptions are fairly rare, however, and their reach is decidedly limited. See, for example, text accompanying note 235. Note, also, that provisions basing liability on implicit understandings and arrangements are not purpose-based exceptions. These provisions apply regardless of a taxpayer's intent behind informal understandings. For instance, Treas Reg § 1.1271-1(a)(1) states that "[a]n intention to call a debt instrument before maturity means a written or oral agreement or understanding not provided for in the debt instrument ... that the issuer will redeem the debt instrument before maturity." Whether a particular agreement between the issuer and the debt holder is oral (rather than written) in order to achieve a tax benefit, comply with some nontax regulatory regime, or for any other reason makes no difference in the tax analysis.

To begin with, the affected taxpayers will need to agree between themselves what the norm is. This agreement, however, will not be enough to assure them that they have correctly identified the relevant custom. Because any social norm reflects the views of numerous individuals, the taxpayers will need to make a judgment about these views. Granted, they have already made a similar judgment simply by adopting a given contractual norm. But for norms that are not particularly strong or clear, this judgment will not have been nearly as precise as the one needed to determine the tax consequences. Most likely, taxpayers will remain uncertain whether their version of a given norm corresponds precisely to the views of others relying on it.

Predicting the government's interpretation of the same customary understanding will be even more hazardous. By definition, norms are unstated, undocumented, and underspecified. The likelihood that the IRS or a court will misinterpret a contractual norm is substantial (and higher than in a case of a written contract). Moreover, taxpayers will have no assurances that their interpretation of the norm will be heard at all. The tax consequences of this norm may be established in litigation involving others. If so, taxpayers will need to make a further determination whether the norm considered in that litigation is so similar to the one they use that they should follow the tax treatment chosen by the court. Sometimes the answer will be obvious; in other cases it will be hopelessly unclear.

Difficulties with ascertaining the tax treatment of a norm under the new law will often add further uncertainty. Today, parties often conduct no tax analysis of tax-neutral and tax-relevant norms. If these norms are treated as part of contracts, difficult tax issues may arise. For example, prior to the 1970s repo litigation, the repo market participants may have believed that repos consisted of two independent sales, each producing easily computable taxable gains and losses.[251] They did not worry about a tax recharacterization in the absence of express repurchase agreements. If these market participants were told that the government would treat their contractual norms as legally binding, the tax analysis would become not just different, but uncertain. If a repo consisted of express sale and repurchase contracts, it would be far from clear that the repo should be recast as a secured loan. After all, when the Supreme Court returned to the issue in 1994, it did so to address inconsistent decisions by the highest state courts

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251 The early repo litigation produced inconsistent results. Compare *First National Bank in Wichita v Commissioner of Internal Revenue*, 57 F2d 7, 9 (10th Cir 1932) (taxpayer loses), with *Bank of California v Commissioner of Internal Revenue*, 80 F2d 389, 390 (9th Cir 1935) (taxpayer wins); *Wells Fargo Bank and Union Trust v Commissioner of Internal Revenue*, 80 F2d 390, 390 (9th Cir 1935) (taxpayer wins).

that could not agree on the tax treatment of repos that *did* have express repurchase agreements.[252] Thus, substituting a formal obligation for an informal norm may complicate the tax analysis, not simplify it.

One may expect that at least the taxpayers using the tax-driven norms would know exactly what would happen upon the new law's enactment. Even here, however, uncertainty is likely to increase. Admittedly, if the confidentiality norm were treated as a binding obligation, the tax analysis would be straightforward—taxpayers would have to disclose all confidential contracts. Very often, however, a tax-driven norm is used not to escape a clearly undesirable tax result, but to strengthen the case for a taxpayer-favorable conclusion.

For instance, if a hedge fund is viewed as acquiring a loan participation immediately after the loan is initiated (rather than two days later), or if a holder of appreciated stock is taxed as if she lent her shares when she entered into a VPF (and not three months later), these taxpayers' tax liabilities would not necessarily change. For the hedge fund, the real question is whether it was involved in negotiating the loan or was a mere passive investor. Many practitioners believe that it is easier to argue in favor of the passive investor characterization if the loan is acquired sometime after its origination.[253] Few of them would concede, however, that foregoing the delay leads to an inescapable conclusion that the hedge fund is involved in a U.S. trade or business. Rather, they would see the case as more uncertain.[254] Similarly, for the stock-hedging shareholder, the issue is whether the loan and VPF are parts of the same "agreement." Even if the forward seller signs both contracts at the same time, it is not crystal clear that they are.[255] It is unlikely, but not impossible, that the term "agreement" as it is used in § 1058 is not much broader than the term "contract." If so, the forward seller wins even if she enters into the loan and prepaid forward simultaneously, as long as the two contracts are separately documented and not tied to each other too closely.

At the very least, taxpayers relying on tax-driven norms know that documenting these norms (or treating them as if they were documented) changes the tax analysis. With norms of other types this will be far from clear. The tax analysis of contractual norms is not something that comes naturally to businesspeople. Most of them will have

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252 See *Nebraska Department of Revenue v Loewenstein*, 513 US 123, 127–28 (1994).

253 See Sheppard, 108 Tax Notes at 732 (cited in note 72).

254 For a list of factors that would affect a practitioner's opinion, see, for example, Leeds, 107 Tax Notes at 235–37 (cited in note 72) (listing fourteen factors, including whether the hedge fund participates in negotiating the underlying bank loan, and whether the fund has the right to enforce or amend the loan documents).

255 See Schizer, 101 Colum L Rev at 1355 (cited in note 63).

no idea what are the tax implications of the government's decision to treat all of their customary arrangements as legally binding.

For all these reasons, indiscriminate taxation of all contractual norms will expose taxpayers to all of the ambiguities inherent in unstated customary practices and in their tax analysis, introducing considerable uncertainty. Taxpayers will have a choice of reducing this uncertainty or living with its consequences. At least five possible responses come to mind. Some taxpayers will start documenting their informal understandings, some will stop relying on them, some will forego any documentation or abandon their transactions altogether, and some will continue as if nothing had changed. All five types will incur additional costs.

2. The cost of doing nothing.

The choice to do nothing will produce a clear inefficiency. Taxpayers who make no behavioral adjustments in response to the new law will have several reasons to worry discussed above. In addition, they may reasonably expect that the IRS will step up enforcement efforts in implementing this law. If so, these taxpayers will become more likely audit targets, raising the risk of adjustments related not just to the norm-based exchanges, but to the rest of their returns as well. The chance of penalties is slight, but real.[256] Additional concern will come from the possibility that the contractual relationship will end in dispute. At this point, one of the taxpayers may decide not to follow the unstated norm. If the tax law treats that norm as part of the contract and if the norm is tax relevant, deviating from it may itself produce adverse tax consequences.

Taxpayers anxious about all these unpleasant possibilities incur risk-bearing losses—a species of deadweight loss. Because the new law gives these individuals additional reasons to worry but does not make them change their behavior, these taxpayers are worse off while nobody else benefits.[257] Their worrying is a pure social waste.

To be sure, any legal change introduces some uncertainty and gives rise to risk-bearing losses. Because the uncertainty considered here will be particularly great, the risk-bearing losses produced by an indiscriminate attack on contractual norms will be especially significant.

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256 See, for example, Raskolnikov, 106 Colum L Rev at 582 n 57 (describing audit rates below 1 percent), 620 & n 206 (noting a penalty imposition rate of 4.1 percent) (cited in note 222).

257 See id at 635–36 (arguing that taxpayers will experience "risk-bearing losses solely due to the possibility, but not certainty, of being penalized").

3. The cost of responding.

Will taxpayers who respond to the government's decision to tax all contractual norms fare any better? Consider first those who decide to document their informal agreements. They will need to come to a common understanding of what precisely these agreements are, but at least they will not need to guess what other contractors and the government think about similar customary arrangements. These taxpayers will clearly have fewer reasons to worry than those who ignore the new law. Similarly, those who abandon any reliance on contractual norms will largely avoid the uncertainty.

This is not to say that the taxpayers in either group will be unaffected by the change. Scholars have argued that for a number of reasons contractual norms are not just efficient, but more efficient than entirely formal written contracts. For instance, informal practices allow contractors to respond to uncertainty and information asymmetries by incorporating future information into their agreements as it arises.[258] Formal contracts are not so flexible.[259] Another reason why contractors rely on norms rather than contracts is to act upon information that is observable ("possible and worthwhile for transactors to obtain"[260]) but not verifiable (not "worthwhile for transactors to prove to a designated third-party neutral in the event of a dispute"[261]). Formal contracts can only be based on verifiable information. Furthermore, contractual norms allow the parties to use a threat of informal sanctions to enforce interior contractual provisions—those whose violation, while costly, is not harmful enough to justify bringing a lawsuit.[262] By definition, these provisions remain unenforced if legal sanctions based on express contractual language are the only option. Similarly, if the breaching party is judgment proof, the only possible enforcement is informal.[263] Yet another reason why contractual norms sometimes outperform written agreements is that some agreements may be simply beyond the reach of public courts. For instance, while the

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258 See Deakin, Lane, and Wilkinson, 21 J L & Socy at 333–35 (cited in note 28).

259 The cost of designing a sufficiently well-specified contractual provision that depends on future information may be larger than the provision's expected benefit. See Scott, 94 Nw U L Rev at 862 (cited in note 33); Bernstein, 144 U Pa L Rev at 1789 (cited in note 9).

260 Bernstein, 144 U Pa L Rev at 1791 (cited in note 9).

261 Id. See also Scott, 94 Nw U L Rev at 863 (cited in note 33) (arguing that when "the parties cannot observe key economic variable[s,] [or, alternatively,] they cannot verify those [variables] to courts," they will enter into incomplete contracts).

262 See Bernstein, 99 Mich L Rev at 1761 (cited in note 10); David Charny, *Nonlegal Sanctions in Commercial Relationships*, 104 Harv L Rev 373, 394 (1990).

263 See Charny, 104 Harv L Rev at 394.

U.S. legal system is "toothless to enforce credit sales for diamonds,"[264] informal norms do the job just fine.

More generally, it appears highly plausible that contracting parties often prefer to use two different sets of rules in their interactions. To borrow Lisa Bernstein's terminology, the parties use relationship-preserving norms (RPNs) when they cooperatively resolve minor disputes.[265] They switch to endgame norms (EGNs) if the relationship is seriously damaged or irreparable.[266] Contractors administer RPNs themselves, but they design EGNs to be applied by a neutral third party. EGNs are found in written contracts; RPNs are developed and enforced through contractual norms. Without restating Bernstein's entire argument, it is enough to note that there is no reason to expect that RPNs and EGNs will be the same. In fact, contractual neoformalists have argued convincingly that these norms should differ, perhaps significantly.[267]

For taxpayers considering how to react to the new law that treats all contractual norms as legally binding, this discussion highlights a serious problem. Neither documenting nor abandoning their norms would preserve the value of their contractual relationships. Norms perform an important function, so eliminating them would be costly. But they perform it only as long as they remain informal, so documenting them would be costly as well.

On the bright side, these costs will be absent for norms that are tax driven or tax neutral. In the former case, the arguments about efficient norms do not apply. In the latter, the parties will be safe in their continuing reliance on tax-neutral norms under the new law. By definition, treating these norms as binding or nonbinding has no tax effect.

Without a comprehensive tax analysis of existing contractual norms (and this Article is at best a first step in this direction), it is difficult to judge what portion of contractual norms is tax neutral. I suspect, however, that it will be often unclear whether a given norm is tax neutral or not. The tax law has rules for phantom income,[268] deemed

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264 Richman, 31 L & Soc Inquiry at 392 (cited in note 11) (noting that the ease with which a diamond merchant can steal, hide, and transport diamonds makes it particularly difficult for a formal legal system to prevent theft).

265 See Bernstein, 144 U Pa L Rev at 1796 (cited in note 9).

266 See id.

267 See id at 1797–98; Robert E. Scott, *A Relational Theory of Default Rules for Commercial Contracts*, 29 J Legal Stud 597, 615 (1990) ("The parties, in essence, have learned to behave under two sets of rules: a strict set of rules for legal enforcement and a more flexible set of rules for social enforcement.").

268 See, for example, Lee A. Sheppard, *News Analysis: Can Corporate Issuers Dial Up an Overstated Interest Deduction?*, 86 Tax Notes 587, 589 (2000) (referring to "phantom income" produced by contingent payment debt instruments); Mark P. Gergen, *Subchapter K and Passive*

interest,[269] deemed dividends,[270] deemed redemptions and distributions,[271] deemed repayments and reissuances,[272] and all sorts of other esoteric and imaginary events. The tax law's several extrastatutory doctrines further increase the possibility that for tax purposes, transactions are not what they seem.[273] My preliminary guess is that many taxpayers are likely to find that even after investing considerable sums in tax advice they have no certain answer about whether many of their norms are clearly tax neutral. These taxpayers may well decide to either document their norms or abandon them, incurring the costs just discussed.

Or they may do something that is even worse. If the informal understanding is critical to the entire agreement, and if documenting it is impossible or extremely costly, the contractors may respond to the new law by foregoing any formalization, or by abandoning their transactions altogether. In the former case, taxpayers will no longer be able to achieve the optimal allocation between formal and informal enforcement, leading to inevitable welfare losses.[274] In the latter, they will lose not only the added value of relying on a contractual norm, but the basic value of the exchange itself.

To the extent the new law inhibits the use of tax-neutral norms, it produces a pure deadweight loss. But if the additional cost falls on those who use tax-relevant and tax-driven norms, there is a clear offsetting benefit. Norm-based transactions allow taxpayers to reduce their tax burden, in effect shifting it to other taxpayers. The new law will reduce these undesirable effects, that is, it will diminish the cost of norms. This is a familiar situation where reducing a socially harmful (costly) behavior is itself costly. The point of this discussion is that in addition to the typical costs of stronger enforcement or other base-

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Financial Intermediation, 51 SMU L Rev 37, 60 (1997) (noting that REMICs and FASITs produce "phantom income" which has the potential of escaping taxation).

269 See, for example, Bittker and Lokken, *Federal Taxation of Income, Estates and Gifts* at ¶ 55.3.2 (cited in note 86) (referring to interest deemed paid under 26 USC § 7872 (2006)).

270 See, for example, Bittker and Eustice, *Federal Income Taxation of Corporations and Shareholders* at ¶¶ 3.16, 13.44 (cited in note 179) (referring to deemed dividends in the context of § 351 exchanges and consolidated return regulations). See also 26 USC § 351 (2006).

271 See, for example, id at ¶ 9.23[2].

272 See Treas Reg § 1.1272-1(c)(6) (treating, upon certain contingencies, a debt instrument as retired and reissued solely for the purpose of calculating original issue discount).

273 See text accompanying notes 166–69. No doubt, this is why tax issues appear with remarkable regularity in the most unexpected places. Junior corporate associates are taught to call tax lawyers on the dullest run-of-the-mill deals because one never knows what seemingly innocuous change in the documents may produce adverse tax consequences.

274 See Klein, 34 Econ Inquiry at 455–56 (cited in note 61) (explaining why combining informal enforcement with legally binding contractual terms allows the contractors to economize on private enforcement capital).

broadening measures,[275] attacking all contractual norms will produce a separate cost by reducing (sometimes to zero) the expected value of many contractual relationships.

One further cost must be taken into account. It can be phrased in economic terms (and added to other inefficiencies just discussed), but it seems that more than pure rationality is involved here. While businesspeople negotiate and enter into written contracts all the time, they often resist full formalization of their agreements.[276] They view very detailed contracts and frequent citation to contractual clauses as betraying a lack of trust.[277] While these taxpayers operate in the world of dollars and cents, they prefer settling disputes by adjusting future deals, not by making payments.[278] Even strangers who enter into isolated arm's length transactions sometimes deliberately make their agreements so indefinite that only informal enforcement is possible.[279] Thus we should not be surprised that according to several practitioners, some loan-initiating banks prefer *not* to enter into written agreements that require hedge funds to acquire loan tranches in two days in the absence of a material adverse change. Apparently, these bankers believe that a contractual norm gives them more protection than a binding agreement with a material adverse effect clause. Whether the informal aspects of contractual relationships provide a signaling device,[280] or serve to fulfill some deeper human need,[281] forcing transactors to abandon or reduce

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275 For an analysis of these costs, see, for example, Slemrod and Yitzhaki, *Tax Avoidance, Evasion, and Administration* at 1447–49 (cited in note 196).

276 As one merchant explained, "[T]here are some aspects of a deal that aren't written down because there is a sense that they are better dealt with as gentlemen on an as-needed basis. I would be reluctant to deal with someone who wanted to include such things in his confirmatory memoranda." Bernstein, 144 U Pa L Rev at 1790 n 88 (cited in note 9). Of course, lawyers meticulously document mergers, acquisitions, major credit facilities, and other large-stakes contracts in full accord with their clients' wishes. Major transactions are relatively rare, however. Besides, as the study of the private placement market shows, even relatively large borrowings are accompanied by an informal norm to renegotiate the covenants. See Carey, et al, 66 Staff Series at 37 (cited in note 244).

277 See, for example, Beale and Dugdale, 2 Brit J L & Socy at 47 (cited in note 16) (reporting that "salesmen ... [and] buyers ... both said that any attempt to shelter behind contractual provisions or even frequent citation of contractual terms would destroy the firm's reputation very quickly"); Macaulay, 28 Am Sociological Rev at 64 (cited in note 16) (arguing that demanding a very detailed contract "indicates a lack of trust and blunts the demands of friendship, turning a cooperative venture into an antagonistic horse trade").

278 See, for example, Beale and Dugdale, 2 Brit J L & Socy at 59 (cited in note 16). See also Bernstein, 99 Mich L Rev at 1783–85 (cited in note 10).

279 See Scott, 103 Colum L Rev at 1644–45 (cited in note 17) (positing that many recently litigated cases regarding indefinite, unenforceable contracts involved "isolated transactions in heterogeneous markets between strangers trading at arm's length").

280 See Posner, *Law and Social Norms* at 25–27 (cited in note 23).

281 For instance, evidence suggests that roughly half of individual contractors have a preference for fairness and reciprocity. See Scott, 103 Colum L Rev at 1663–67 (cited in note 17).

their informal interactions will contradict their revealed preferences, resulting in an additional intangible cost.

The emerging picture is not a happy one. Attacking only tax-driven norms will be inadministrable and may be arbitrary. Taxing all norms, while easier in practice, will introduce unique inefficiencies. Since neither solution is particularly appealing, the next section considers a compromise that, while far from ideal, may be more administrable than the first approach and less costly than the second.

D. A Workable Solution: A Multifactor Approach

In most cases, it will be impossible to prove conclusively that a given norm is tax driven. But it is possible to identify the specific features that, when combined, are likely to lead the government to tax-driven norms and tax-relevant norms that are particularly costly.

1. A sudden change in contractual terms.

A change in typical contractual terms following a change in the tax law is the first feature on the list. The need for confidentiality of tax shelter proposals did not disappear with the enactment of the tax shelter regulations. When confidentiality agreements and contractual clauses gave way to confidentiality disclaimers, the same business need had to be fulfilled by some other means. The confidentiality norm emerged as the primary enforcement mechanism. The lesson is that a commercial requirement that can no longer be met by an explicit contract term will likely be satisfied by an informal contractual norm. Thus, if shortly after a change in the tax law a typical piece of contractual language disappears or is significantly revised in a similar fashion in many analogous contracts, a norm is likely to replace it, and this norm is likely to be tax driven.

2. A divergence in transactional patterns.

Another telltale sign of a tax-driven norm is a divergence in transactional patterns that has no apparent explanation. When some holders of appreciated stocks enter into VPFs and simultaneously lend their appreciated shares, while others wait for some time to enter into a share lending agreement, it is worth thinking about contractual norms.[282] The immediate stock lending suggests a business preference. It also creates a tax problem. A delay helps the tax argument but is contrary to the parties' economic objectives. Some taxpayers accept a

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[282] Another example supporting this analysis is immediate versus delayed acquisition of loan tranches by hedge funds.

higher tax risk while others agree to pay a price in uncertainty of relying on a contractual norm to gain a stronger tax position. A divergence in transactional patterns follows. Especially where such divergence corresponds to a difference in the aggressiveness of the respective tax positions, the more conservative taxpayers are likely to use a tax-driven norm.

3. Significant tax benefits.

Contractual norms that produce significant tax benefits are also suspect. All else being equal, there is a higher chance that small tax benefits are merely accidental. Put another way, taxpayers are more likely to invest in developing a tax-driven norm if the payoff is substantial.

The correlation is imperfect. The repo norm was almost certainly not tax driven, yet it had the potential to produce substantial tax savings for repo buyers. Perfection is not the goal, however. All tax-externalizing norms are socially costly, and attacking them will be most justified where these costs are particularly significant.[283] Furthermore, each factor discussed in Part V.D is bound to misidentify some norms as tax driven (or even tax relevant). The proposed aggregate approach will be more precise, however, because it suggests that only when a number of factors indicate that a norm should be challenged should the government treat it as legally binding for tax purposes. In the case of the repo norm, for example, neither of the first two factors was present. This does not mean that the IRS was mistaken in focusing on this norm, only that other norms will be more obvious candidates for an attack.

4. Strong and clear norms.

In choosing which contractual norms to scrutinize, the government should take account of their strength and clarity to assure that the tax law is consistent in permitting tax-motivated transactions that expose taxpayers to real risks. As an added benefit, this inquiry further increases the likelihood that a given norm is tax driven.

As discussed above, only strong and clear norms are really similar to contractual provisions. Furthermore, vagueness and weakness are unlikely in a tax-driven norm. Taxpayers who accept market risk to achieve desirable tax results widely use sophisticated financial instruments to reduce this risk as much as possible. We should expect that tax-

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283 A large tax benefit means a large externality. Whether intentional or not, a large externality is more inequitable than a small one, and it is more likely to create a significant allocative distortion. For both reasons, large externalities are more justifiable targets even if the norm producing them is tax relevant rather than tax driven.

payers who improve their tax positions by taking a risk of relying on legally unenforceable arrangements will attempt to eliminate most of this risk as well. They can do so by making their tax-driven norms strong and clear. The scarce evidence available thus far supports this insight.

At the same time, generic norms simply cannot be tax driven. They are also likely to be weak, vague, or both. Hence, the government should discern and attack only the most specific practices in a given "family" of norms.[284]

The suggested inquiry into the strength and clarity of a norm is exactly the same as the one required if the government attacks tax-driven norms directly. The difference is in the weight placed on the correct determination. Where this inquiry is a part of a multifactor test, the consequences of mistaken assessments are smaller. Because courts have little experience in evaluating contractual norms, this is a welcome result.

5. Non–arm's length terms.

When unrelated commercial actors engage in transactions that demonstrably lack arm's length terms, tax-driven norms may well be in play. Hedge funds and financial institutions do not ordinarily buy and sell assets for above- or below-market price, yet this is exactly what they do when they follow the loan origination norm. Stock owners usually charge a so-called borrow fee when they lend large blocks of shares, but they forego this fee when banks borrow the shares pledged under a VPF.[285] Non–arm's length (re)sales were a quintessential feature of the repo markets until the fixed-price repurchase norm

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284 For instance, a tax-driven norm accompanying similar transactions that take place in New York and Dallas may differ in important details. If so, only a norm specific to each area is clear. A deal between New York and Dallas contractors who decide to rely on that norm will expose the parties to a meaningful risk because each side has a different view of the norm's precise meaning. Similarly, the norm in New York may be followed almost uniformly while in Dallas merely sometimes. Only the New York norm is strong in this case. In sum, the proposed inquiry into the strength and clarity of a norm is functional. The key question is the magnitude of risk incurred by the parties as a result of not formalizing a given understanding, not some platonic notion of what it means to be "strong" and when something is "clear." This analysis should be modified in case of the family commitment norm because this norm accompanies all sorts of interactions in an unaltered form. If it is treated as legally binding in any case, it will have to be treated as such for all purposes—an unattractive alternative. The current law's solution to this problem seems to be right. Instead of treating the family commitment norm as legally binding or ignoring it altogether, the current rules focus on individual transactions. Thus, the related party rules attack specific instances of the family commitment norm's use rather than the norm itself.

285 The typical borrow fee ranges from twenty to fifty basis points (hundredths of a percent) depending on the liquidity of the stock. See Sheppard, 110 Tax Notes at 16–17 (cited in note 69). Taxpayers who lend the stock in connection with a VPF forego this fee in exchange for a better price under the VPF, a price based on the unstated VPF stock lending norm. See id at 16 ("[W]hile no prepaid forward contract is conditioned on a share loan, the price paid always is.").

was abandoned in the mid-1980s.[286] While not tax-driven, the repo norm produced a large tax externality.

Admittedly, the government's struggle with non–arm's length exchanges has a long history, and its success in identifying and attacking these exchanges has been decidedly mixed.[287] The difficulty typically arose, however, because the suspect transactions took place between related taxpayers and had no obvious market equivalents. This problem does not exist for many norm-based exchanges. While sometimes it will be costly to determine whether a particular deal between unrelated taxpayers has arm's length terms,[288] in many cases (like with the "free" stock lending related to a VPF) the answer will be obvious. If unrelated transactors are unable to explain why their exchanges deviate from market terms, there is a good chance that they are relying on tax-externalizing norms.

6. Sophisticated taxpayers.

Sophisticated taxpayers are more likely to develop tax-driven contractual norms than those lacking tax and financial acumen. In addition, attacking all contractual norms used by these taxpayers is less costly in general. For both reasons, tax sophistication should be one of the factors taken into account in deciding how to deal with a contractual norm.

A norm cannot be tax driven unless the taxpayers using it understand the tax issues involved. For instance, to rely on the confidentiality norm, one must be aware, at a minimum, of the disclosure requirement in the Treasury regulations. While the requirement is quite straightforward, we can hardly presume that all (or most) businesspeople have a working knowledge of these regulations.

Moreover, the level of legal sophistication required to take advantage of a tax-driven norm is often well beyond basic. For instance,

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286 See Stigum, *The Repo and Reverse Markets* at 218–21 (cited in note 117).

287 To appreciate the government's difficulties, one needs to go no further than the recent regulations under 26 USC § 482 (2006) issued to assure that prices paid for services provided by related taxpayers are arm's length. The regulations span forty pages in the Federal Register, and follow an earlier version criticized by taxpayers. See generally 71 Fed Reg 44466 (2006); Lee A. Sheppard, *News Analysis: Selected Issues in the New Transfer Pricing Service Regs*, 113 Tax Notes 122 (2006). Transfer pricing provisions—rules aimed to ensure that transactions among related taxpayers have arm's length terms—have been called "the intersection of bad tax policy and bad tax administration." Id at 123.

288 For instance, pricing of VPFs is complicated and no liquid markets for VPFs exist. Thus, it will be difficult for the IRS to prove that a particular VPF price is not arm's length. Similarly, because the delay in purchasing loan participations is only two days, it may not be easy to establish that a particular loan tranche is purchased for an above- or below-market price, especially if the interest rates changed little during the intervening two-day period.

a tax lawyer without special training may be simply unable to recognize the requirement that an NPC must provide for multiple payments. Nor would this lawyer be able to decide what minimum number of payments is necessary to secure the NPC treatment. Yet these skills are needed just to see the problem that was solved by the early swap termination norm. Thus, it will often take sophisticated tax experts merely to discern how a tax-driven norm works.[289]

Many businesspeople have a subtle understanding of their products' pricing and design, the dynamics of a business negotiation, and so on, but this knowledge does not translate into even rudimentary tax proficiency. As we have seen, many transactors prefer to operate without getting lawyers involved. When they finally seek legal advice, the advisor is typically a commercial lawyer, not a tax expert. Businesspeople usually do have a working relationship with the tax accountants who prepare their returns. However, at least for small- and medium-size businesses, these accountants are likely to save their clients' money by aggressively reading vague but simple statutory provisions (such as whether a particular expense is deductible).[290] Audit rates for these taxpayers are low and their tax returns are fairly generic, so this approach tends to work reasonably well.

Large businesses and very wealthy individuals are audited much more often.[291] Large businesses are also required to file additional schedules that make audits easier.[292] These taxpayers should be ex-

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289 Not every taxpayer who belongs to a norm environment will need to talk to a highly skilled tax lawyer. Some will learn about tax-driven norms from business partners or contractual counterparties. But for a tax-driven norm to develop, at least a significant number of taxpayers must receive assurances that the norm will work from tax lawyers who are capable of doing the analysis.

290 It is well known that the use of tax return preparers increases taxpayers' aggressive interpretation of ambiguous provisions. See, for example, Steven Klepper, Mark Mazur, and Daniel Nagin, *Expert Intermediaries and Legal Compliance: The Case of Tax Preparers*, 34 J L & Econ 205, 226 (1991). Because the IRS severely restricts access to detailed tax return data, see id at 221, these studies are not detailed enough to distinguish between simple and complex ambiguities. However, it appears reasonable to assume that tax return preparers working for small- and medium-size businesses (many of whom are CPAs rather than tax lawyers) do not have the same grasp of sophisticated tax planning as the elite tax lawyers who advise major financial institutions, Fortune 500 companies, multibillion dollar hedge funds, and extremely wealthy individuals.

291 See, for example, Allen Kenney, *Everson Touts Increased IRS Enforcement in Fiscal 2004*, 105 Tax Notes 1071, 1071–73 (2004) (noting that in 2004, the audit rate for individuals with incomes below $100,000 was 0.77 percent, for small businesses it was 0.32 percent, for corporations with assets of $10 million and more it was 16.81 percent, and for corporations with assets of $250 million and more it was 40.05 percent); Allen Kenney, *IRS Disputes Study Claiming Millionaires Face Fewer Audits*, 111 Tax Notes 13, 14 (2006) (reporting that in 2005, the audit rate for taxpayers with incomes of $1 million and more was around 5 percent).

292 See Raskolnikov, 106 Colum L Rev at 585, 591 (cited in note 222) (discussing Schedule M-1 and its successor, Schedule M-3).

pected to look for more complicated ways of reducing their tax liabilities. In fact, they have already found them.

Sophisticated taxpayers (and their tax advisors) have embraced the congressional approach of allowing tax-motivated transactions as long as taxpayers expose themselves to sufficient risk. If Congress does not allow them to fully hedge their appreciated financial positions without recognizing the built-in gain, they will keep some of the unwanted economic exposure. If they have to wait for thirty-one days before repurchasing a security sold at a loss, they will wait. To be sure, these taxpayers have succeeded in minimizing the amount of market risk they actually incur.[293] Yet they assume some risk nonetheless.

This suggests that it is not just possible that the sophisticated taxpayers use tax-driven norms, it should be expected. If they are prepared to accept one form of risk as a price for achieving a desirable tax result, why not agree to a different type of uncertainty? Keeping partial exposure to fluctuations in the market price of a stock that the taxpayer no longer wants is quite similar to relying on a bank's willingness to terminate a swap on short notice without any obligation to do so. Both strategies expose the taxpayer to uncertainty and both offer tax savings as a prize. Because we have seen such a wide use of the former strategy by financially sophisticated taxpayers, we should expect them to adopt the latter strategy as well. If so, the likelihood of misidentifying a norm as tax driven is smaller for these tax planners.

Furthermore, many unique inefficiencies resulting from an attack on all contractual norms will not be large in the case of sophisticated taxpayers. These individuals already have a close working relationship with tax lawyers. They already engage in complicated tax planning. If there is any group for which the cost of ascertaining the effect of the new law that treats all contractual norms as legally binding is relatively small, sophisticated taxpayers are such a group.

Again, the sophistication criterion is imperfect. It is not crystal clear who is sophisticated and who is not. The dot-com millionaires who hardly lacked business acumen now claim that they were innocent victims confused and fooled by shrewd tax shelter promoters.[294]

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293 See, for example, Schizer, 82 Taxes at 67 (cited in note 241) (describing end runs around wash sale rules); Dana L. Trier and Lucy W. Farr, *Constructive Sales under Section 1259: The Best Is Yet to Come*, in 16 *Tax Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations & Restructurings* 1217, 1223 (PLI 2002) (describing taxpayers' opportunities to reduce the bite of constructive sale rules).

294 See generally, for example, Sheryl Stratton and Crystal Tandon, *Year in Review: Shelter Fight Shifts to Tax Professionals' Conduct*, 110 Tax Notes 51 (2005) (describing lawsuits by tax shelter investors against the law firms of Sidley Austin Brown & Wood and Jenkens & Gilchrist, the accounting firms KPMG and BDO Seidman, and the financial institutions Bank One and Deutsche Bank).

Perhaps some of them were. Still, tax sophistication is highly relevant in deciding whether a norm is tax driven and should be used as one of the factors informing the ultimate conclusion.

7. Inefficient use of reputational capital.

While economic theory is often too abstract to be applied in solving specific tax problems, one of its insights may be easily used to reach many costly contractual norms. Scholars studying self-enforcing contracts have developed a concept of reputational capital and explained its importance in understanding contractual relationships.[295] Reputational capital is the value of the contractor's reputation in the relevant marketplace.[296] The higher it is, the less concerned is the contractor's counterparty with devising legally enforceable constraints on the contractor's opportunistic behavior. Because the party with significant reputational capital would think long and hard before violating unstated contractual norms and damaging her valuable reputation, she is more trustworthy than a transactor whose reputation has little value.

This insight suggests that when rational contractors search for the optimal combination of formal and informal enforcement mechanisms, they should place more reliance on informal enforcement in the case of the party with more reputational capital.[297] Numerous observations of commercial relationships strongly support this insight. For instance, in the private placement debt market, lenders have a larger reputational capital than borrowers because transaction frequency is significantly higher for the former than the latter.[298] A lender makes many loans, and if it violates the unstated contractual norm just once, it will find fewer borrowers willing to transact on the customary lender-favorable terms in the future. A defection by a borrower, on the other hand, is not nearly as costly. The borrower may not need to access the private placement market any time soon, or ever, so its tarnished reputation in this particular environment may cost the borrower very little. Thus, it is no accident that strict, legally enforceable covenants constrain borrowers while lenders' promises to renegotiate

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295 See, for example, Roy W. Kenney and Benjamin Klein, *How Block Booking Facilitated Self-Enforcing Film Contracts*, 43 J L & Econ 427, 434 (2000) (arguing that parties to film contracts "economiz[e] on limited reputational capital" by relying on both formal and informal enforcement); Klein, 34 Econ Inquiry at 449–50 (cited in note 61).

296 Klein, 34 Econ Inquiry at 449 (cited in note 61).

297 See id at 459–60 (noting that uneven levels of reputational capital explain why parties who have less reputational capital routinely agree to seemingly unfair contracts with parties who have more reputational capital).

298 See Kenney and Klein, 43 J L & Econ at 432 n 14 (cited in note 295) (linking reputational capital to repeat transaction frequency); Klein, 34 Econ Inquiry at 459 (cited in note 296) (same).

these covenants are backed by informal sanctions. Using the reputational capital of the party that has more of it is efficient because it allows the parties to minimize the total cost of contracting. Plenty of other examples support this insight.[299]

Let us now consider how reputational capital is used by the adherents to some tax-driven norms. In the case of confidential tax shelters, the party with more reputational capital is clearly the promoter. A tax shelter client is likely to enter into significantly fewer tax shelters than the promoter is likely to sell. Yet it is the client's reputation that is used to complete the enforceable contract with the informal confidentiality term. Similarly, while the VPF customer has decidedly less reputational capital than its counterparty bank (each VPF client usually enters into very few VPFs while the counterparty banks have numerous VPF customers),[300] delay in stock lending forces the bank to rely on the client. These uses of reputational capital are inefficient. Considerations that have nothing to do with maximizing the expected value of the contractual relationship skew the optimal allocation of formal and informal enforcement mechanisms. Apparently, the tax benefits exceed the costs of suboptimal contracting.

This observation presents a clear opportunity. Any contractual norm that forces a party with superior reputational capital to rely on a party with inferior reputational capital (that is, the party that enters into significantly fewer transactions of a given type) should be suspect. This arrangement is inefficient and the inefficiency may well be tax related. As always, this factor is imperfect. Reputational capital may be evenly distributed.[301] When it is clearly higher for one of the parties,

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299 Similar allocations of formal and informal enforcement have been observed in the movie industry, see Kenney and Klein, 43 J L & Econ at 432, 434 (cited in note 295) (describing the movie industry's continuing reliance on norms that make exhibitors who lack reputational capital rely on distributors who possess substantial reputational capital), the shoemaking industry, see text accompanying notes 134–36 (describing a system in which machine buyers with little reputational capital relied on the informal promises of United Shoe and other machine manufacturers who kept these promises in order to protect their reputations in the market), and the labor market in general. The reputational capital theory explains why termination at will clauses are so pervasive in employment contracts. Employees whose reputational capital is small are bound by formal contractual provisions. Employers whose reputation with numerous other employees (and future employees) is at stake are constrained by a contractual norm that they will not terminate without cause even though they have a legal right to do so. See Klein, 34 Econ Inquiry at 460 (cited in note 61).

300 We should keep in mind that VPF clients and banks typically enter into many transactions with each other, not just the VPFs. Even taking this into account, banks have more capital at stake. Each bank has numerous VPF clients while each VPF client interacts with only a handful of banks.

301 If each contractor transacts in a given market with comparable frequency, the reputational capital is distributed evenly and it is difficult to argue that any particular use of reputational capital is obviously inefficient. These situations are not uncommon. For instance, repo

tax considerations may just happen to align with an efficient arrangement.[302] These imperfections do not detract from the usefulness of the proposed analysis, however, as long as the absence of inefficient reputational capital allocation is interpreted not as a taxpayer-favorable feature, but only as a neutral one.

8. Preserving valuable norm environments.

The last factor will be difficult to describe in the statute or the regulations, but the IRS should take it into account nonetheless. Social norms do not develop in a vacuum, and they usually do not exist in isolation. It takes a Shasta County for norms to develop, and more than one norm exists in Shasta County.

Virtual Shasta Counties are just as effective in incubating social norms. The American whaling community in the nineteenth century,[303] the orchard growers in the Pacific Northwest,[304] the diamond industry,[305] the grain and feed industry,[306] the cotton industry,[307] the lobster industry,[308] the chemical industry,[309] the repo market,[310] the private placement debt market,[311] and the tax shelter market, too, are all examples of what I have called "norm environments."[312] All these environments have a number of norms. Attacking any of these norms would affect the rest.

We have already considered the unique inefficiencies that will arise once the government tells taxpayers that all of their contractual norms will be treated as binding for tax purposes. If, without committing to this broad attack, the government decides to tax only one (or just a few) norms in a given environment, taxpayers will expect that

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buyers and sellers, as well as swap-dealer banks and hedge funds trading in CDSs, are constrained by contractual norms to the same extent. The same analysis applies to grain merchants and cotton traders, all of whom rely on each other's nonenforceable commitments. See text accompanying notes 132–33 (describing the use of in-house weights by grain merchants), 148 (noting delays in documenting sales by cotton traders).

302 For example, the tax-driven early swap termination norm forces foreign traders to rely on financial institutions, reflecting an efficient allocation of reputational capital.

303 See Ellickson, *Order without Law* at 191–206 (cited in note 4).

304 See Cheung, 16 J L & Econ at 29–30 (cited in note 14).

305 See generally Richman, 31 L & Soc Inquiry 383 (cited in note 11); Bernstein, 21 J Legal Stud 115 (cited in note 11).

306 See generally Bernstein, 144 U Pa L Rev 1765 (cited in note 9).

307 See generally Bernstein, 99 Mich L Rev 1724 (cited in note 10).

308 See generally Acheson, 1 J L, Econ, & Org 385 (cited in note 13).

309 See Thomas M. Palay, *Comparative Institutional Economics: The Governance of Rail Freight Contracting*, 13 J Legal Stud 265, 278 (1984).

310 See generally Stigum, *The Repo and Reverse Markets* (cited in note 117).

311 See generally Carey, et al, 166 Staff Studies 4 (cited in note 244).

312 I have referred to "norm environments" to avoid the decidedly positive flavor of the more accepted term "norm community." See, for example, Sunstein, 96 Colum L Rev at 947 (cited in note 19).

their other be challenged as well. If nothing else, the norm environment has already drawn the government's attention, so further scrutiny is likely. Moreover, having already found the norms it does not like, the government will be less sympathetic to other norms used by the same taxpayers. Thus, the inhabitants of this environment will perceive a threat to all of their norms. Therefore, they will incur some of the same costs that would arise if the government attacked all of these norms directly. These costs are the collateral damage of attacking even a few contractual norms.[313]

While this damage is probably inevitable, it will not be the same in all environments. To take tax shelters as the first example, it is clear that the confidentiality norm was not the only one involved. Tax shelter clients used to rely on tax opinions that assumed business purpose without inquiring into the meaning of this assumption. Lawyers writing these opinions made the assumption without learning about the taxpayers' business (often because they did not know who their client was). Alternatively, the opinion simply stated that it would not address anti-abuse doctrines, or would take into account only some of the facts.[314] Inexplicably, taxpayers accepted these obviously flawed opinions. They were tempted, in part, by an informal understanding that if a court or the IRS disagreed with the opinion's conclusion, the opinion author would refund some or all of the fees.[315] Advisors who believed that a particular strategy was illegal or very aggressive counseled their clients to seek advice elsewhere rather than urging them to walk away from the scheme.[316] It was understood that this was how business was being done. Those who decided to take advantage of the tax shelter savings accepted these understandings. It appears that the numerous norms in the tax shelter environment have something in common: all (or almost all) of them are tax driven.

For those who worry about collateral damage, this is an easy case. None of the informal practices in this environment are socially valuable, so there is no reason to worry about inhibiting any of them. Quite the contrary, this is a desirable result. Even if the government identifies and

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313 Of course, a similar mechanism would give rise to inefficiencies in all norm environments if the government attacks any norms at all. The link, however, will be much more attenuated, so the costs will be lower.

314 See David M. Schizer, *Enlisting the Tax Bar*, Tax L Rev (forthcoming 2007) (describing "partial opinions" that would make unrealistic assumptions or assert unreasonable caveats).

315 See, for example, Kyle D. Logue, *Tax Law Uncertainty and the Role of Tax Insurance*, 25 Va Tax Rev 339, 382–83 (2005) (positing that agreements to refund fees where the opinion turned out to be faulty were "likely to be part of an implicit understanding").

316 See Braithwaite, *Markets in Vice* at 114 (cited in note 47) (synthesizing tax shelter promoter's advice to a client that "[i]f other lawyers from whom you solicit an opinion think the shelter is illegal . . . they will counsel you not to consult them").

attacks a single tax shelter norm, other similar norms will be negatively affected. A collateral detriment turns into a collateral benefit.

Consider now a more difficult case. The examples discussed throughout this Article show that U.S. lending markets are full of contractual norms. It is also quite likely that some of them, such as the hedge fund loan origination norm, are tax driven. But it is almost certain that many other norms in this environment are tax relevant or tax neutral. As Marcia Stigum learned from money market participants, they view themselves as being "in a business in which people say, 'My word is my bond,' and mean it."[317] The norm of renegotiating private placement covenants supports this observation with the evidence from a different segment of the same market.[318] Even if we focus our inquiry just on the subsection of the market that involves hedge funds and financial institutions, the problem remains. The same parties that rely on a tax-driven loan origination norm also enter into billions of dollars of partially documented credit default swaps relying on each other's words and weakening the hedge funds' tax position. No matter how you slice it, there are socially valuable contractual norms involved, and inhibiting them would be costly.

This discussion is not meant to restrict the government response only to environments where all norms are tax driven. Clearly, however, it is worth studying the entire norm environment before attacking any particular norm. As clearly, it is more efficient to focus on the environments where most norms are tax driven, where few tax-neutral norms exist, or where there are relatively few norms period.

9. Evaluating the multifactor approach.

The proposed multifactor test is a first effort to arrive at a balanced approach to reducing the tax-related social cost of social norms. It may look similar to the current law's facts-and-circumstances inquiry, but it is not. The existing doctrinal solution has no current denominator, other than the instruction for the courts to consider all available information. It relies heavily on intent and purpose. And because it is generic, it does not allow the courts to seize on the common features of norm-based tax avoidance. A bewildering variety of references to informal and implicit arrangements and understandings scattered throughout the Treasury regulations does little to clarify the

317 Stigum, *The Money Market* at 625 (cited in note 118).

318 One can respond that perhaps defining the environment as the entire U.S. debt market is too imprecise. In part, this is an empirical question that turns on the perceptions on those involved. If attacking a tax-driven norm in any part of the debt market alarms all debt market participants, the debt market is the right level of generality at which to describe the environment.

tax analysis of contractual norms. The tax law's treatment of informal agreements is at once too crude and too obscure.

In contrast, the proposed test narrows the inquiry, adopts several easily administrable factors, and eschews analysis of intent.[319] To be sure, *any* effort to reduce the deadweight loss of tax planning (including the one undertaken in this Article) must focus on taxpayer motivations. By definition, this deadweight loss arises only when taxpayers change their behavior *with an intent* to reduce their taxes. However, it is also well understood that direct inquiries into intent are not the only means of reaching tax-motivated transactions.[320] Because intent behind a custom is especially difficult to determine and prove in court, an intent-based test is particularly inadequate in dealing with contractual norms. In addition, welfare losses caused by tax-relevant norms should not be ignored, especially when the tax externality is large. An intent-based test will overlook these losses completely.

At the same time, a careful analysis of tax-driven norms has revealed several typical traits of these informal agreements. Some of these traits—such as significant tax benefits, non–arm's length terms, and sophisticated taxpayers—will look familiar to those studying tax avoidance. Yet these characteristics have not been consistently used as a group to attack tax-motivated transactions. Other features—such as a sudden change in contractual terms, a divergence in transactional patterns, presence of strong and clear norms, and inefficient use of reputational capital—are identified and analyzed in this Article for the first time. By relying on all of the proposed factors, the government will end up attacking tax-driven and particularly inefficient tax-relevant norms without undertaking the all but impossible task of proving the subjective intent of numerous taxpayers and while keeping costs to a minimum.

A reasonable implementation of the suggested strategy would be to issue regulations (perhaps backed by explicit congressional authorization) stating that certain customary practices that exist among the parties to written contracts will be treated as part of those contracts for tax purposes regardless of their legal enforceability under

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319 In many cases, deciding whether the tax benefit is large, whether the taxpayer is sophisticated, and whether there is either a document adjustment in response to a tax law change or a divergence in transactional patterns will not be particularly difficult.

320 For instance, while some approaches—such as the economic substance doctrine, the step transaction doctrine, and certain sections of the Code—require direct inquiries into taxpayers' motivations, see text accompanying notes 170–74, 235, other provisions—such as passive loss limitations, capital loss limitations, and many risk-based rules—use proxies to reach tax-motivated transactions. See 26 USC § 469 (2006) (passive loss rules); 26 USC § 1211 (2006) (capital loss limitations); Daniel N. Shaviro, *Risk-Based Rules and the Taxation of Capital Income*, 50 Tax L Rev 643, 645–46 (1995) (risk-based rules).

state law. The regulations will go on to explain that the government will use a facts-and-circumstances approach, relying especially on the factors outlined above, to determine which specific customary practices will be so treated. Several examples based on those discussed in this Article will clarify the government's position.

E. Finding Contractual Norms

Once the government decides what to do with costly contractual norms, how does it find them? Here the existing social norms literature is quite helpful. Scholars have long identified the paradigmatic traits of any norm environment.[321] The IRS can and should use these known signs to search for the settings where contractual norms are likely to exist.

Once the "suspect" settings are identified, the government should actively seek information about contractual norms. Simple measures will go a long way. For instance, auditors may start asking taxpayers whether they frequently deviate from the specific contractual terms in dealing with suppliers, customers, or counterparties, whether they often act in a certain way without being legally obligated to do so, and the like. Of course, those who use norms to evade (that is, flagrant tax cheats) will not answer honestly (just as cartel members will not confess that they belong to a cartel). These taxpayers are not likely to be a large group, however. Once one decides to lie to the government, why rely on norms at all?

On the other hand, I suspect that many taxpayers use tax-relevant contractual norms without realizing their tax effects. Others knowingly reduce their taxes by relying on informal understandings precisely because they believe that this type of tax planning works. All these taxpayers would have no reason to lie about their use of contractual norms, and these are not the types who would lie in any case. Thus, the government may obtain valuable new insights about norm-based tax planning from simple and inexpensive enforcement measures.

Voluntary disclosure during audits is hardly the only source of information. Once the government announces its concern about the use of informal customary practices in tax planning, it may receive a few "plain brown envelopes" describing such practices, just as it receives these envelopes describing today's tax shelters from time to time.[322]

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321 See text accompanying note 96.

322 See, for example, Mark P. Gergen, *The Logic of Deterrence: Corporate Tax Shelters*, 55 Tax L Rev 255, 257–58 (2001) (noting that the government "has been helped . . . by informants who tell it about new aggressive strategies, sometimes even passing on offering documents"); Schizer, 101 Colum L Rev at 1335 (cited in note 63) (noting that "competitors are often willing to offer anonymous tips" to the government).

Furthermore, once auditors learn about the government's concern they may rethink some arrangements they already know about but did not consider to be problematic.

Moreover, the government is certain to learn about taxpayers' use of contractual norms simply by taking action. As it usually does, the Treasury department will initially issue the regulations containing the multifactor test suggested here in a proposed form. As they always do, taxpayers, including the Bar Associations and interest groups, will use the notice and comment period to highlight imperfections in the proposed rules. In the process of explaining to the government why the regulations are too broad, vague, or otherwise deficient, these taxpayers will almost certainly shed light on the inner workings of contractual norms.[323]

Perhaps counterintuitively, some tax-driven norms may not be particularly hard to find. Admittedly, adherents to these norms loathe government attention and recognize that strong norms are more likely to be detected by the IRS.[324] Yet, some practitioners believe that their clients see strength in numbers. If numerous hedge funds delay purchasing loan participations for the same two-day period, the argument goes, they strengthen their case that two days is a sufficient delay to protect the funds from being engaged in a U.S. trade or business.[325] This "herd mentality," as one practitioner put it, may provide a partial explanation of how tax-driven norms emerge in the first place. In any case, it suggests that some of these norms are so widely followed that detecting them will not be especially difficult.

Several features discussed earlier as typical of tax-driven norms are also relatively easy to spot. A sudden change in customary contract terms and an inexplicable divergence in transactional patterns are hard to conceal. The government knows already, for example, that

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323 For an example of a bar report that contains a wealth of information about the transactions in question in addition to their tax analysis, see NY State Bar Association, 109 Tax Notes 347 (cited in note 103).

324 Thus, it is no accident that information about the strong and clear VPF stock lending norm has been publicly available for some time. See note 66. The hedge fund loan origination norm is no secret either. See note 83.

325 See Braithwaite, *Markets in Vice* at 109 (cited in note 47) ("[I]f a shelter 'is structured into enough big plays, then the IRS is not game to overturn it.' . . . [T]he point can be reached where the best way to protect clients from hostile IRS action is for the shelter to be 'too big to fail.'"). This is similar to the unstated, yet quite strong, "Wall Street Rule" according to which it is believed that the government will not challenge tax treatment of publicly traded securities once a certain total volume of such securities has been issued. See, for example, Lee A. Sheppard, *News Analysis: Having It Both Ways on Feline PRIDES*, 106 Tax Notes 632, 632 (2005) (noting that once the Treasury Department allows a "critical mass of a particular hybrid security to be issued before considering it," it will refuse to question the security's tax-favorable intended treatment).

tax shelter documents no longer have confidentiality provisions and that some hedge funds wait for a few days before acquiring loan participations while others do not. These are red flags signaling a likely use of tax-driven norms. The concept of inefficient use of reputational capital may sound rather abstract, but it is really quite easy to grasp and apply. Sometimes, the lack of arm's length terms is obvious.

An additional common feature of many norm-based environments is that they include financial institutions. Banks participate in the repo market, the money market, and the private placement market. They serve as counterparties on prepaid forwards, cross-border equity swaps, and credit default swaps. They originate loans assisting hedge funds in lending to U.S. borrowers, and they are an indispensable part of the tax shelter business.[326] Even the cotton traders report that only three banks do most of the lending and are intimately involved in the affairs of all of their cotton merchant clients.[327] With the recent wave of consolidation in the financial services industry, this phenomenon is unlikely to subside.

Some of the norms used by the banks and their counterparties are tax driven, some are clearly not. The last thing I want to imply is that the banks are a unique group of exceptionally aggressive and shrewd tax avoiders. Quite the opposite, the banks' involvement with contractual norms has a simple and benign explanation. Their relatively small number, their role as financial intermediaries, and the long-term, multifaceted relationships with most of their clients are particularly conducive to norm-based interactions. Nonetheless, it does appear that the government should pay particular attention to financial institutions if it decides to do something about tax-driven norms.

One final observation suggests that while finding contractual norms may become harder, attacking tax-driven norms may well be-

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326 The list of banks involved in structuring or facilitating aggressive tax-motivated transactions is long. It includes, in alphabetical order, ABN (Algemene Bank Nederland N.V., a Dutch bank), Babcock and Brown, Bank of America, Bank One, Deutsche Bank (a German bank), HVB (Bayerische Hypo-Und Vereinsbank AG, a German bank), HSBC, ING (a Dutch bank), Merrill Lynch, Rabobank (a Dutch bank), UBS (Union Bank of Switzerland, a Swiss bank), and Wachovia. See *Wachovia Bank v Schmidt*, 546 US 303 (2006) (Wachovia Bank); *TIFD III-E v United States*, 459 F3d 220 (2d Cir 2006) (Babcock and Brown, ING Bank N.V., and Rabo Merchant Bank N.V.); *ACM Partnership v Commissioner of Internal Revenue*, 157 F3d 231, 233 (3d Cir 1998) (ABN and Merrill Lynch); Sheryl Stratton, *German Bank Admits Criminal Wrongdoing in Tax Shelter Case*, 110 Tax Notes 820 (2006) (HVB); George T. Wendler, *HSBC Bank Officer Testifies about Bank's Role in Tax Havens*, Tax Notes Today 148-39 (Aug 1, 2006) (HSBC Bank USA); Calvin H. Johnson, *Tales From the KPMG Skunk Works: The Basis-Shift or Defective Redemption Shelter*, 108 Tax Notes 431, 433 (2005) (UBS); Stratton and Tandon, 110 Tax Notes at 51, 52 (cited in note 294) (Bank One, Deutsche Bank); Sheryl Stratton, *SILOs: Abusive Tax Scams or Real Business Deals*, 102 Tax Notes 301, 303 (2004) (Bank of America).

327 See Bernstein, 99 Mich L Rev at 1747, 1753 (cited in note 10).

come easier. There are some indications that the heyday of contractual norms is behind us. Technological innovation,[328] managerial professionalization,[329] changing business models,[330] and other factors[331] combine to increase transactors' reliance on express contracts at the expense of informal norms. The CDS norm is disappearing, too, as the market participants adopt new contractual solutions to speed up confirmations and novations of credit default swaps.[332]

Yet the point should not be overstated. Commentators have argued convincingly that at least one of the reasons for contractual norms' existence is that transactors deliberately allocate different aspects of their relationships to formal and informal realms precisely because this maximizes the total value of their interactions.[333] While the factors enumerated in the preceding paragraph may well affect the relative allocations, it appears highly unlikely that it will ever be optimal for contractors to forego informal enforcement entirely.

A less emphasized reason for the existence of contractual norms is transactional innovation. For instance, experienced practitioners believe that contractual norms have been so prevalent in the CDS market simply because CDS is a relatively new financial product. They recall that when interest rate swaps appeared over two decades ago, they were also highly informal. Foreign currency swaps were apparently hardly documented at all, at least in their infancy. As each financial product matured, the degree of documentation increased. These examples suggest that, among other things, contractual norms accompany emerging products and transactional structures. Since this type of innovation is unlikely to disappear, neither are the contractual norms. Thus, whether the increased formalization is a cyclical phenomenon or an irreversible trend is somewhat uncertain. Even if contractual norms are in a permanent decline, they will not disappear overnight.

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328 See id at 1786 n 233 (explaining that changes in mill production methods and ways of grading cotton quality may "undermine the ability of industry institutions to promote cooperation").

329 See Beale and Dugdale, 2 Brit J L & Socy at 51 (cited in note 16) (arguing that the "new professionalism among young managers" is the likely cause of "a gradual change in attitude towards tightening up procedures and creating legally enforceable agreements").

330 See Richman, 31 L & Soc Inquiry at 415 (cited in note 11) (arguing that the increasing reliance on direct marketing by DeBeers, development of Internet diamond brokerages, and increasing use of low-cost diamond cutters may bring the norm-rich environment of Jewish traders to an end).

331 See Stigum, *The Money Market* at 625–27 (cited in note 118) (observing that "money market folk felt, *at least until recently*," that they operated in an environment where one's word was one's bond, and attributing increased formalization to a string of high-profile bankruptcies) (emphasis added).

332 See Raisler and Teigland-Hunt, 25 Intl Fin L Rev at 44–45 (cited in note 105) (describing development of more user-friendly documentation for the credit default swap market).

333 See, for example, Bernstein, 144 U Pa L Rev at 1796 (cited in note 9); Scott, 94 Nw U L Rev at 852 (cited in note 33).

On the other hand, there is no reason to expect that tax-driven norms are on the brink of extinction. As sophisticated taxpayers are increasingly prepared to accept limited risk as the price of achieving a desired tax result, tax-driven norms may well become more popular. If so, the share of all contractual norms that are tax driven is likely to increase. Once the IRS finds contractual norms, it may stumble into tax-driven norms simply by luck.

In sum, it is quite clear that the government has a variety of ways to identify norm environments and to acquire considerable knowledge about norm-based tax planning. Only when this is done will we able to evaluate the full scope of the problem. Even the preliminary assessment undertaken in this Article supplies plenty of evidence, however, that contractual norms are ubiquitous, some of them are costly, and these costs can be reduced with a measured response. There is no excuse not to consider it.

VI. GOING BEYOND CONTRACTUAL NORMS . . . OR NOT

The challenges of devising a balanced response to the tax-motivated uses of contractual norms are bound to multiply once we expand the inquiry to commercial norms in general. The analytical tools developed in studying contractual norms will remain useful. Noncontractual commercial norms may be tax driven, tax relevant, or tax neutral. They also may vary in strength and clarity. All these distinctions will affect the tax analysis in ways similar to those discussed above.

Despite the similarities, however, noncontractual commercial norms differ from contractual ones in important respects. These differences strongly suggest that noncontractual commercial norms are better left alone. Some of the reasons underlying this conclusion are practical, some doctrinal, and some conceptual. Shasta County is a good test case to consider all of them.

To start with, Shasta County is an environment where most of the day-to-day commercial interactions remain entirely informal. No contracts are written, no payments are made, and in most cases, nothing is expressly negotiated at all. Taxing norm-based exchanges in this setting makes even less sense than taxing barter transactions. Yet, the IRS makes no serious attempts to collect taxes arising from these transactions,[334] presumably due to severe administrative difficulties.[335]

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[334] Note, however, that "barter exchanges" must provide information to the IRS. See 26 USC § 6045(a), (c) (2006) ("The term 'barter exchange' means any organization of members providing property or services who jointly contract to trade or barter such property or services.").

If a farmer and a rancher trade a calf for some feed, at least there is a clear (barter) exchange that is difficult, but possible, to identify. If a farmer borrows a bulldozer from a rancher and gives nothing in return (or so it seems), identification of the taxable exchange becomes all but impossible. Without an exchange, there is nothing to tax. Thus, practical considerations suggest that as long as barter transactions remain outside of the government's collection net, so should the entirely informal norm-based exchanges.

The bulldozer loan, but not the calf-for-feed trade, also presents a doctrinal issue. It is possible that the former (but clearly not the latter) may be viewed as a gift for tax purposes. The line between nontaxable gifts and taxable transfers is murky and fact specific. The neighborly interactions among the Shasta County residents do not fit easily into either category. Clearly, farmers and ranchers act not just out of "detached and disinterested generosity"—the tax law's test for gifts announced by the Supreme Court decades ago.[336] To the contrary, Ellickson tells us about the "mental accounts" maintained by the Shasta County locals to keep track of what each of them has done for their neighbors and what each has received in return—the accounts that must be kept in rough balance at all times.[337] Nevertheless, when neighbors help neighbors, a quid pro quo that is so obvious in a barter exchange is less apparent, and an altruistic motivation that is definitely absent in a barter exchange is undeniably in the picture. At the same time, most transfers commonly referred to as gifts also have elements of reciprocity.[338] Quite possibly, even clearly nontaxable gifts are not as "detached and disinterested" as the Supreme Court assumed. For all of these reasons, the question whether a particular norm-based provision of goods or services is a gift for tax purposes—a question of fact to be decided by a jury based on its experience with "the mainsprings of human conduct"[339]—may be answered in the affirmative, at

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335 Stronger enforcement efforts here are almost certainly not justified. While many barter transaction take place, the tax liability arising from most of them is small, while the cost of identifying them is considerable. Furthermore, calculating the tax owed is difficult because the value of the exchanged assets is often uncertain. Thus, administrability considerations direct the government collection efforts elsewhere.

336 See *Commissioner of Internal Revenue v Duberstein*, 363 US 278, 285 (1960).

337 See Ellickson, *Order without Law* at 55–56 (cited in note 4).

338 See, for example, Robert C. Ellickson, *Unpacking the Household: Informal Property Rights around the Hearth*, 116 Yale L J 226, 304–09 (2006) (citing voluminous literature on gift exchanges); Posner, *Law and Social Norms* at 50 (cited in note 23) ("[A]lmost all gift-giving takes place within relationships of exchange."); George A. Akerloff, *Labor Contracts as Partial Gift Exchanges*, 97 Q J Econ 543, 549–51 (1982) (reviewing and agreeing with anthropological literature emphasizing the reciprocal nature of gifts). Those who think otherwise are invited to stop giving birthday presents to their loved ones and observe the consequences.

339 *Duberstein*, 363 US at 289.

least in some cases. This doctrinal uncertainty makes pursuing norm-based exchanges in largely informal settings even less attractive.

Finally, what would happen if IRS agents start telling farmers that borrowing a bulldozer is a taxable lease and that there must be some hidden payment to the lender? At the very least, this enforcement effort would give a very different articulation to the existing neighborly relationships, an articulation that is likely to have an effect on the relationships themselves. Interactions based partly on mutual advantage, but largely on goodwill and altruism, will be viewed as more like the former type and less like the latter. Even for a utilitarian, this is an unattractive result.[340]

People hate commodifying relationships. If a long-time resident greets a new family that just moved into the area with a homemade pie (a custom in some American suburbs), the quickest way for the newcomers to ruin their reputation is to offer (or, worse yet, insist on) a cash payment in return. Shasta County has a strong norm against monetary compensation for personal efforts extended to help one's neighbors. According to Ellickson, "[t]he introduction of what is appropriately called 'cold, hard cash' can signal distance and poison the atmosphere of a relationship."[341] In some cases, when monetary sanctions replace informal disapproval, the undesirable behavior increases. Moreover, when the sanctions are later withdrawn, the old norms are not restored. Commodification has irreversible negative effects.[342]

Most likely, people derive higher (maybe considerably higher) utility from informal interactions than from formal transactions that involve explicit payments. If so, forcing taxpayers to think of their relationships as profit extraction devices lowers the marginal utility derived from these relationships and leads to an inefficient shifting to more formalized exchanges. The likelihood of this outcome, when added to the practical and doctrinal concerns, strongly suggests that the government should not attempt to tax norm-based interactions that take place in Shasta County and other environments characterized by similarly high levels of informality. To be sure, these dealings

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340 For those who give less weight to rationality and view intangible aspects of human interactions as independently valuable, forcing people to think like rational egoists is even more problematic.

341 Ellickson, *Order without Law* at 78 (cited in note 4). Similarly, Washington orchard growers developed a "custom of the orchards" obligating each grower to keep the same density of pollinating bee hives as their neighbors; yet the growers denied the existence of any contract among them governing the employment of hives. See Cheung, 16 J L & Econ at 30 (cited in note 14).

342 See generally Uri Gneezy and Aldo Rustichini, *A Fine Is a Price*, 29 J Legal Stud 1 (2000) (describing the results of a study where the frequency of parents arriving late to pick up their children from several day care centers increased when the centers instituted fines for late pick ups and did not decrease after centers abolished the fines).

sometimes allow inhabitants to reduce their tax liabilities, but there are good reasons to accept this cost and move on.

This concession, however, does not undermine the importance of seeing the whole picture. Even if we decide not to tax entirely informal transactions that involve noncontractual commercial norms, it is important to remember that the ability to participate in these transactions is not uniform. For instance, when considering special tax subsidies to small farmers, new investment in rural infrastructure, or any other program that would disproportionately benefit this group of taxpayers, we should keep in mind that they are likely to face a lower tax rate than it appears otherwise because they rely on informal arrangements much more often than an average salary-earner. I do not mean to single out small farmers. As discussed above, the social norms literature has given us a useful list of features typical of most norm environments. The government should use this knowledge to identify and study other settings where wholly informal norm-based interactions are prevalent. The resulting information will be highly relevant in devising all sorts of social programs, both tax and transfer, that will benefit or disadvantage the members of particular groups that are likely to rely on strong commercial norms.

CONCLUSION

Modern social norms used in commercial relationships have at least one significant social cost, and it is tax related. The deadweight loss resulting from tax-driven norms and the tax-shifting externalities produced by tax-driven and tax-relevant norms reduce social welfare. Once this cost is identified, it appears obvious. Yet it is not surprising that scholars have not considered it until now.

Most social norms scholars have no expertise in the tax law. Most tax academics are largely unaware of the way in which transactions are actually carried out. And most tax practitioners (all too aware of the role played by the customary practices) have no time or interest in abstracting from the details of their specific deals. While this divergence may be particularly acute in tax, I suspect that other areas of the law present similar problems. This makes social norms a difficult subject to study.

The Article offers an insight into norm-based tax planning, identifies the tax cost of social norms, and evaluates alternative courses of action aimed at reducing this cost. The Article's approach has an inherent contradiction. Norms are complicated. The better we understand them, the more difficult it is to find an acceptable solution. In fact, policymakers may well conclude that the best the government can do in the end is to deal with the costly norms on a case-by-case basis, as it has been doing for decades.

I do not believe that this is the best approach. Even in the absence of a precise and easy solution, the government can develop a measured response and reduce the cost of contractual norms by relying on the proposed multifactor test. In any case, this Article's analysis of the tax implications and social welfare costs of numerous contractual norms will help policymakers and scholars look for and evaluate alternative solutions.