Paul L. Caron

Tax Archaeology

> *[A] reported case does in some ways resemble those traces of past human activity–crop marks, post holes, the footings of walls, pipe stems, pottery shards, kitchen middens, and so forth, from which the archaeologist attempts, by excavation, scientific testing, comparison, and analysis to reconstruct and make sense of the past. Cases need to be treated as what they are, fragments of antiquity, and we need, like archaeologists, gently to free these fragments from the overburden of legal dogmatics, and try, by relating them to the evidence, which has to be sought outside the law library, to make sense of them as events in history and incidents in the evolution of the law.*[1]

Tax Stories, the first in a new series of *Law Stories* books published by Foundation Press, reports the result of archaeological digs into ten seminal U.S. Supreme Court federal income tax cases by ten leading tax scholars.[2] The book explores the historical contexts of these cases and the role they continue to play in our current tax law. Each of the ten chapters sets forth the social, factual, and legal background of the case, discusses the various court proceedings and judicial opinions, and explores the immediate impact and continuing importance of the case. The companion web site contains the complete record of the case in the Supreme Court, including the lower court opinions, briefs of the parties and amici curiae, oral arguments (audiotapes and transcripts, where available),[3] and the Supreme Court's opinion.[4]

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[1] A.W. Brian Simpson, *Leading Cases in the Common Law* 12 (1995). *See also* Symposium, *Legal Archaeology*, 2000 Utah L. Rev. 183.

[2] Ten is, of course, not a magic number. Indeed, other books in the *Law Stories* series will profile from 10-15 cases in other subjects. As a David Letterman fan, I initially wanted all books in the series to maintain a "top ten" format but was soon convinced that pedagogy should trump attempts to build a uniform *Law Stories* "brand."

[3] Audiotapes are available for all post-1954 oral arguments. Transcripts are available for all post-1967 oral arguments, as well as for selected oral arguments from 1935-67; there are no transcripts available for pre-1935 oral arguments. Audiotapes and/or transcripts are available for four of the cases profiled in *Tax Stories*: INDOPCO, Inc. v. Commissioner, 503 U.S. 79 (1992) (Chapter 6) (audiotapes and transcript); Schlude v. Commissioner, 372 U.S. 128 (1963) (Chapter 8) (audiotape); United States v. Davis, 370 U.S. 65 (1962) (Chapter 4) (audiotape); and Knetsch v. Commissioner, 364 U.S. 361 (1960) (Chapter 10)

Law Stories books are in the pipeline to cover the entire first-year curriculum−*Civil Procedure Stories* (Kevin M. Clermont, Editor),[5] *Constitutional Law Stories* (Michael C. Dorf, Editor), *Contracts Stories* (Douglas G. Baird, Editor), *Criminal Law Stories* (Robert Weisberg, Editor), *Property Stories* (Gerald Korngold & Andrew P. Morriss, Editors), and *Torts Stories* (Robert L. Rabin & Stephen D. Sugarman, Editors). Other *Law Stories* books will target the second- and third-year curriculum, starting with *Tax Stories*.

At one level, tax is a curious choice with which to begin a new series of books designed to give a behind-the-scenes look at the most important cases in the field. In light of the increasingly statutory and regulatory world that tax has become, Michael Oberst argues that teachers of the basic income tax course should focus on requiring students to master the intricacies of various Internal Revenue Code (the "Code") and regulation provisions rather than "provid[ing] a wide comfort zone for the student" by "spend[ing] considerable time analyzing case law."[6] In contrast, Michael Livingston contends that "technical tax teaching," with its focus on the Code and regulations, should be reserved for tax LL.M. programs, while the J.D. tax curriculum should embrace a "skills" approach emphasizing legal process issues.[7] I believe there is more need now than ever for the basic tax course to re-focus on the pivotal issues reflected in the major cases, rather than the "noise" of the latest tax developments that students will forget (if they ever learned them in the first place) soon after the final exam. With new tax legislation now an almost annual event, along with an increasing torrent of new cases, regulations, and rulings, the basic tax course needs to convey the underlying tax architecture to empower students to understand the tax law du jour. The major cases are the best markers to guide the journey down the tax law's currents and eddies.

Carolyn Jones has bemoaned the failure of tax scholars to join the narrative and storytelling trend in legal scholarship.[8] Her essay "attempts to open tax scholarship to the many and varied tax stories around us."[9] She identifies case law as one of the sources of stories about what she calls "real taxes."[10] It is thus perhaps fitting that *Tax Stories* is the

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(audiotape and transcript). The web site also includes 10-15 minute excerpts of the oral arguments in *INDOPCO*, *Schlude*, *Davis*, and *Knetsch* suitable for classroom use.

[4] http://www.law.uc.edu/TaxStories.

[5] *See* Kevin M. Clermont, *Teaching Civil Procedure Through Its Top Ten Cases, Plus or Minus Two*, 46 St. Louis L.J. ___ (2002).

[6] Michael A. Oberst, *Teaching Tax Law: Developing Analytical Skills*, 46 J. Legal Educ. 79, 80 (1996).

[7] Michael A. Livingston, *Reinventing Tax Scholarship: Lawyers, Economists, and the Role of the Legal Academy*, 83 Cornell L. Rev. 365, 387-88, 430-32 (1998). *See also* George K. Yin, *Simulating the Tax Legislative Process in the Classroom,* 47 J. Legal Educ. 104 (1997).

[8] Carolyn C. Jones, *Mapping Tax Narratives*, 73 Tul. L. Rev. 653 (1998). *See also* Livingston, *supra* note 7, at 366-67 ("Traditional tax scholarship today is comfortable but tired: it is overwhelmingly normative, when much of the academy is experimenting with empirical and narrative norms; methodologically simplistic, when the broader academy has become more sophisticated in economics and other disciplines. Its emphasis on a search for apolitical neutrality would be considered naïve or outdated in other subject areas.").

[9] Jones, *supra* note 8, at 653.

[10] Other sources of stories are the Code, regulations, and tax legislative history. *Id*. at 657.

first entrant in the *Law Stories* series designed to further research into this aspect of storytelling and to bring the fruits of this work to our students.

In tax law, as in other subject areas, there are certain landmark cases that set the law on a path that continues to shape much of the current developments in the field. In these seminal cases, the tax law was faced with a fundamental choice, the resolution of which would influence the tax law for generations to come.[11] In *Tax Stories*, we look at ten pivotal cases in the development of the federal income tax.[12] These stories provide fresh insights into both particular doctrinal areas of tax law as well as issues of wider application across the tax law.

1. *Doctrinal Lessons*

The first four chapters of *Tax Stories* deal with the income side of the ledger. Joseph M. Dodge's opening chapter focuses on perhaps *the* central question in the nascent income tax: the nature of income subject to tax.[13] Yet the tax law struggled with this question for over forty years before the Supreme Court decided *Commissioner v. Glenshaw Glass*[14] in 1955. The narrow holding in the case–that punitive damages recovered by a plaintiff in commercial litigation constitutes gross income–seems quite obvious to us with the benefit of hindsight. Indeed, the doctrine emerging from *Glenshaw Glass*–that "windfall gains" are included in gross income–also strikes us today as the only sensible outcome. But Professor Dodge unearths the great doctrinal and theoretical uncertainty faced by the parties in *Glenshaw Glass* as they struggled to give content to the Code's use of the phrase "gross income." The Court's opinion established two enduring principles of the income tax: (1) that the Code, not language in judicial opinions, is the ultimate source of tax law;[15] and (2) that the term "gross income" in the Code is a catch-all phrase that reaches all accessions to wealth, regardless of source, and not specifically excluded elsewhere in the Code. In addition, *Glenshaw Glass* set the income tax on a modern footing, "free of the clutter and distractions inherited from the nineteenth century and early twentieth century."[16]

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[11] As Yogi Berra would put it, the tax law came to a fork in the road and took it. *Bartlett's Familiar Quotations* 754 (Justin Kaplan ed., 16th ed. 1992).

[12] In compiling this "top ten" list, we culled from an initial list of thirty cases ten cases that (1) are included in all of the major income tax casebooks, (2) are foundational in the sense that they were pivotal in the development of the income tax and continue to shape the existing tax law, and (3) have a particularly interesting story to tell based on their facts and historical context. Indeed, this was one of the more enjoyable aspects of the project, as the eleven of us fiercely debated the make-up of the list through an e-mail discussion group. We recognize, of course, that other tax scholars and commentators might not agree on the precise make-up of our list, but we are confident that our list as a whole satisfies the criteria we established at the outset.

[13] Joseph M. Dodge, *The Story of* Glenshaw Glass: *Towards a Modern Concept of Gross Income*.

[14] 348 U.S. 426 (1955).

[15] Professor Dodge calls this "the *alpha* and *omega* of approaching a federal tax issue." Page ___.

[16] *Id*. at ____ . Among the "clutter and distractions" cast off by *Glenshaw Glass* were discredited prior precedents, tying tax gain to economic gain, restrictive notions of realization (discussed more fully in Chapter 2 of *Tax Stories*), and limited views of in-kind property, in-kind consumption, and dominion and control.

Marjorie E. Kornhauser uses the oldest case in this book, *Eisner v. Macomber*,[17] to tell the story in Chapter 2 of the central doctrine of realization in the tax law through the life and times of Myrtle Macomber.[18] The case riveted the nation in 1920, as the decision was reported on the front page of *The New York Times* and generated much media attention, and its reverberations were felt both on Wall Street and on Capitol Hill. The treatment of realization as a constitutional aspect of income was part and parcel of a struggle between Congress and the Supreme Court over the nature and scope of government that came to be known as the *Lochner* era. But *Macomber's* lasting influence is felt most deeply in the tax law–although it did not invent the realization concept, it embedded it so early and so deeply into the fabric of our tax system that any attempt to eliminate it now would face insurmountable political and institutional obstacles. Professor Kornhauser notes that *Macomber's* embrace of realization encouraged the development of our current hybrid income/consumption tax, and she bemoans the Court's conflicting discussion of whether accretions to capital constitute income because "a system that is neither fish nor fowl can exacerbate complexity, theoretical inconsistencies, and practical inequities."[19] *Macomber's* legacy also can be seen in the many deferral provisions subsequently enacted to give special relief from the realization principle, the taxation of capital gains, and the taxation of corporations as separate entities. Although *Macomber* was decided over eighty years ago, "its restless ghost still walks"[20] in many of the corridors of our existing income tax law.

Debt is an invaluable lubricant in our economy, and Deborah H. Schenk explores in Chapter 3 the all-too-common situation of a borrower who fails to repay her debt.[21] The story begins seventy years ago in the plains of Texas with Kirby Lumber Company's failure to fully repay bondholders.[22] The brevity of the Court's two-paragraph opinion–holding that cancellation of a debt creates income–belies the many exceptions and uncertainties spawned by the case. Professor Schenk explains that the misguided theories undergirding the Court's holding–that Kirby Lumber did not suffer any "shrinkage of assets" under the "freeing-of-assets" theory and did not incur a loss on "the whole transaction" under the Court's prior decision in *Bowers v. Kerbaugh-Empire*[23]–led to decades of confusion which could have been avoided had the Court correctly analyzed the transaction under a loan proceeds theory. Under Professor Schenk's approach, because loan proceeds are excluded from income upon receipt in light of the offsetting obligation to repay, the borrower necessarily enjoys an accession to wealth when she repays less than the borrowed amount, regardless of what she has done with the borrowed funds in the meantime. Although Congress subsequently codified the narrow holding in *Kirby Lumber* in treating cancellation of indebtedness as income under § 61(a)(12), Congress and ultimately the courts have grafted a number of exceptions onto this rule. Professor Schenk surveys these many exceptions and finds that they are often infected by

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[17] 252 U.S. 189 (1920).

[18] Marjorie E. Kornhauser, *The Story of* Macomber: *The Continuing Legacy of Realization*.

[19] Page ____ .

[20] *Id*. at ____ .

[21] Deborah H. Schenk, *The Story of* Kirby Lumber: *The Many Faces of Discharge of Indebtedness Income*.

[22] Kirby Lumber Co. v. United States, 284 U.S. 1 (1931).

[23] 271 U.S. 170 (1926).

the discredited freeing-of-assets and whole transaction theories propagated in *Kirby Lumber*. Finally, Professor Schenk concludes that "the confusion engendered by *Kirby Lumber* and its progeny came home to roost in *Zarin v. Commissioner*,[24] a wonderfully wacky case that engendered four separate opinions in the Tax Court and two opinions in the Third Circuit, all based on different theories that revealed in striking terms the continued uncertainty surrounding the *Kirby Lumber* rule."[25]

Karen B. Brown tells the story in Chapter 4 of how a garden variety divorce between Alice and Thomas Davis in 1955 set the stage for the Supreme Court to finally determine the tax consequences of transfers of property incident to divorce.[26] But the Court's approach in *United States v. Davis*[27]–penalizing the transferor spouse by taxing any appreciation in the transferred property and rewarding the transferee spouse with a fair market value basis in the property–resulted in differing tax consequences for divorcing couples depending on whether they lived in common law or community property states. In addition, the Internal Revenue Service (the "Service") often found itself whipsawed if the transferor spouse misreported the transaction by not reporting the gain in the year of divorce and the transferee spouse claimed a fair market value on a sale of the property many years later when the statute of limitations frequently had run on the transferor spouse's return. Congress responded by equalizing the tax treatment of divorcing couples throughout the fifty states and by empowering the Service to effectively police compliance. Professor Brown notes that "§ 1041 lets the transferor spouse off the tax hook and shifts the tax burden to the transferee spouse through a carryover basis in the transferred property."[28] Since the rate of divorce has roughly doubled since the Davis's divorce in 1955,[29] the tax consequences of transfers of property incident to divorce unfortunately have become increasingly important. The enactment § 1041 reduced, but did not eliminate, *Davis'* influence in the tax law. The impact of *Davis* continues to be felt in the many tax contexts not covered by § 1041, including transfers of property (1) having no ascertainable fair market value, (2) between non-spouses in exchange for non-marital rights (including palimony), (3) to a non-resident spouse, and (4) between former spouses but not incident to a divorce.

The next three chapters in *Tax Stories* turn to the deduction side of the equation. In Chapter 5, Joel S. Newman digs into *Welch v. Helvering*,[30] the seminal case for determining deductible "ordinary and necessary" business expenses.[31] The nature and

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[24] 92 T.C. 1084 (1989), *rev'd*, 916 F.2d 110 (3d Cir. 1990). Indeed, at an early stage the working subtitle of *Tax Stories* was *An In-Depth Look at the Ten Leading Federal Income Tax Cases from* A(rrowsmith) to Z(arin). Again, I was soon convinced that pedagogy should trump cute subtitles.

[25] Page ____ .

[26] Karen B. Brown, *The Story of* Davis: *Transfers of Property Pursuant to Divorce*.

[27] 370 U.S. 65 (1962).

[28] Page ____ .

[29] *See* U.S. Census Bureau, *Statistical Abstract of the United States* 2001 tbl. 68 (121st ed. 2001) (1955 divorce rate of 2.3 per 1,000); U.S. Dep't of Health & Human Services, 50 *National Vital Statistics Report* 1 (June 26, 2002) (2001 divorce rate of 4.0 per 1,000).

[30] 290 U.S. 111 (1933).

[31] Joel S. Newman, *The Story of* Welch: *The Use (and Misuse) of the "Ordinary and Necessary" Test for Deducting Business Expenses*.

background both of the expense in *Welch*–a businessman's repayment of debts of his former business that had been discharged in bankruptcy–and of the Supreme Court Justice who wrote the Court's opinion–Justice Cardozo, whose father had resigned in disgrace from the New York Supreme Court amid allegations of corruption–combined to produce one of the more unfortunate opinions in the Court's tax annals. Professor Newman argues that of the three threads running though the Court's opinion–that the expenses were (1) too "personal" to be deductible, (2) too "bizarre" to be ordinary, and (3) capital and thus nondeductible–Justice Cardozo was "wrong" on the first two and "right" only on the third. Professor Newman writes that "[a]lthough it long ago should have been consigned to the judicial scrap heap, *Welch's* spirit lives on in the unfortunate doctrine stifling business innovation at the very time that the twenty-first century global economy demands more, not less, business creativity."[32] Professor Newman's chapter undoubtedly is the only piece of tax literature containing country and western ditties penned by both the Tax Court and the Service, as well as a closing tax limerick!

In Chapter 6, Joseph Bankman picks up on the capitalization v. deduction theme, as well as the role of the background of the Justice who wrote the Supreme Court's tax opinion, as he unravels the most recent case in *Tax Stories*,[33] *INDOPCO, Inc. v. Commissioner*.[34] Business expenses that produce benefits beyond the year they are incurred must be capitalized rather than deducted currently; the capitalized expenses are amortized or depreciated as the asset declines in value, and the remaining basis is deducted when the asset is sold or declared worthless. But as Professor Bankman notes, "in many situations there is no natural line of demarcation between expenses that produce lasting benefit and those that do not . . . [and] it is often difficult even to estimate the proper amortization of capitalized expenses."[35] Over time, courts and the Service have agreed on the treatment of certain categories of expenses within this framework; litigation, as with the expenses incurred in the "friendly" acquisition of INDOPCO, occurs in areas outside of those categories. Although the opinion in *INDOPCO* was written by Justice Blackmun, "the most knowledgeable tax jurist to ever sit on the Court,"[36] Professor Bankman argues that the decision "must be seen as a failure."[37] It is replete with confusing language and unnecessary dicta that have allowed the Service to apply *INDOPCO* in an overly aggressive manner over the past decade. But in the end, the fault may lie in the income tax itself, which requires Solomonic judgments about short- versus long-term benefits of expenses and amortization schedules that mere mortals in the courts and the Service are incapable of consistently getting right. Unless and until we embrace a consumption or cash flow tax system in which *all* business expenses are deductible regardless of the length of the benefit, the best we can hope for is for the courts and the Service "to come up with some workable rules that balance administrative ease against the distorted effects inherent in misclassifying an expenditure

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[32] Page ____ .

[33] Joseph Bankman, *The Story of* INDOPCO: *What Went Wrong in the Capitalization v. Deduction Debate?*.

[34] 503 U.S. 79 (1992).

[35] Page ____ .

[36] *Id*. at ____ .

[37] *Id*. at ____ .

(as a deductible expense or capital investment) or adopting the wrong amortization schedule."[38]

George K. Yin returns to the subject of debt in Chapter 7 and tells the story of how Beulah Crane laid the foundation for the modern tax shelter.[39] In determining her gain on the sale of an apartment building, the question was whether nonrecourse indebtedness secured by the property was includable in her amount realized. Professor Yin points out that the government's victory in *Crane v. Commissioner*[40] was its most pyrrhic one in the tax field, as it permitted taxpayers to include nonrecourse debt in basis as well and thus provided high-octane leverage to the available depreciation deductions. Subsequent courts elaborated on these twin aspects of the *Crane* rule and also clarified the tax treatment of post-acquisition nonrecourse debt. In the end, the government's "tunnel-vision," in insisting that Crane report the nonrecourse debt in her amount realized on sale because she had included it in her depreciable basis,[41] opened the door for the tax shelter scourge of recent years and led to many legislative and judicial responses. To be sure, as Professor Yin notes, "although the *Crane* rule was an integral part of tax shelters, the rule, on its own, was not the cause of shelters. Other tax rules–the allowance of depreciation deductions in excess of economic depreciation, the taxation of *Tufts*[42] gain at preferential tax rates, the failure to distinguish interest from principal payments for tax purposes, the deferral permitted by the installment sale rules, to name a few–were necessary to produce the shelters in conjunction with the *Crane* rule."[43] But "[t]he flaw of the *Crane* rule–a not insignificant one in retrospect–is that it did nothing to *restrain* tax shelter activity once the economic, tax, and other conditions in this country made it ripe for such activity. Instead, it magnified the inadequacies of the other tax rules. In order to prevent shelters, it relied upon a degree of perfection among the other rules, and a level of compliance among taxpayers, that were probably unrealistic expectations of any tax system."[44]

The final three chapters of *Tax Stories* leave the income-deduction matrix and focus on three pervasive income tax issues. In Chapter 8, Russell K. Osgood tells the story of *Schlude v. Commissioner*,[45] the third in a trilogy of cases[46] holding that tax accounting under the Code may differ from generally accepted accounting principles

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[38] *Id*. at ____ .

[39] George K. Yin, *The Story of* Crane: *How a Widow's Misfortune Led to Tax Shelters*.

[40] 331 U.S. 1 (1947).

[41] Professor Yin also notes that the government's litigation strategy also may have been shaped by concerns about other taxpayers avoiding gain on debt-financed property despite claiming earlier depreciation deductions, as well as by concerns about the administrative practicality of the opposite rule that would have awarded the full measure of depreciation to the mortgagee until payments were made on the nonrecourse debt.

[42] Commissioner v. Tufts, 461 U.S. 300 (1983).

[43] Page ____ .

[44] *Id*. at ____ .

[45] 372 U.S. 128 (1963).

[46] The other two cases are American Auto. Ass'n v. United States, 367 U.S. 687 (1961), and Automobile Club of Mich. v. Comm'r, 353 U.S. 180 (1957).

("GAAP").[47] Although the case arose forty years ago, the issue is ripped from today's headlines as the tales of accounting scofflaws like Enron, Global Crossing, Tyco, and WorldCom can be traced in part to the *Schlude* trilogy's sanctioning of departures in tax accounting from GAAP. President Osgood observes that "the decoupling of tax accounting from financial accounting clearly makes sense in certain areas in light of the divergent purposes of each: in tax accounting, the pressure is to minimize taxable income (and thus tax liabilities) via decreasing income/increasing deductions; in financial accounting, the pressure is in the opposite direction to maximize book income (and thus stock prices) via increasing revenues/decreasing expenses."[48] But "[a]t the end of the *Schlude* trilogy, it is hard to find articulable standards for when a business using the accrual method of accounting may be obligated to diverge from its method in order to 'clearly reflect' income for tax purposes, except that it will occur when the Commissioner so insists."[49] The shortcomings of the common law approach sanctioned by the *Schlude* trilogy regrettably are all too apparent today.

One issue that has dogged the income tax since its beginning has been the identification of the appropriate taxpayer to be taxed on the receipt of income. The issue initially arose in the context of husbands purporting to shift income to their wives (who were in a lower tax bracket) because the early income tax did not allow joint returns by married couples. Patricia A. Cain unravels the Supreme Court's foray into this early debate with its *Lucas v. Earl*[50] decision.[51] Professor Cain tells the story behind the income-sharing arrangement between Guy and Ella Earl, including the important role Guy Earl played in the economic development of Northern California and the tax planning objectives of the 1901 agreement. A key part of the story is the structure of the early income tax and the disparity in treatment between spouses in common law and community property states caused by the inability to file a joint tax return. In refusing to allow Ella Earl to be taxed on one-half of Guy Earl's income, Justice Holmes penned undoubtedly the most famous horticultural metaphor in tax jurisprudence: "There is no doubt that the statute could tax salaries to those who earned them and provide that the tax could not be escaped by anticipatory assignments . . . and we think that no distinction can be taken according to the motives leading to the arrangement by which the fruits are attributed to a different tree from that on which they grew."[52] The immediate result of *Earl* (and the subsequent *Poe v. Seaborn*[53] decision) was that spouses in community property states were treated more favorably with respect to earned income than spouses in common law states. Congress responded to this problem in 1948 by enacting the modern joint return. The spirit of *Earl* also lives on in the hoary fruit-and-tree metaphor, which courts to this day continue to apply to cases raising assignment-of-income issues in a wide variety of contexts. Professor Cain doubts Holmes foresaw that some would

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[47] Russell K. Osgood, *The Story of* Schlude: *The Origins of the Tax/Financial Accounting GA(A)P*.

[48] Page ____ .

[49] *Id*. at ___ .

[50] 281 U.S. 111 (1930).

[51] Patricia A. Cain, *The Story of* Earl: *How Echoes (and Metaphors) from the Past Continue to Shape the Assignment of Income Doctrine*.

[52] *Id*. at 114-15.

[53] 282 U.S. 101 (1930).

convert his metaphor into a talisman, rigidly requiring that earnings be taxed to the tree that produced them. She applauds Holmes for reaching the correct result in the case to protect the integrity of the income tax's progressive rate structure: "That principle, protection of progressivity, should guide us today as we determine whether it is appropriate to tax income to the assignor or the assignee."[54]

Daniel N. Shaviro uses *Knetsch v. United States*[55] to tell the story of how courts have struggled since the inception of the income tax to draw a line between permissible tax planning and impermissible tax shelters.[56] The struggle never has been more difficult than it is today, as courts are called upon to deploy judicial doctrines hatched in a very different era to increasingly sophisticated and abstruse tax-savings strategies. As the media maw chews over the tax shelter strategies of much of corporate America, and congressional committees and the Administration contemplate their next steps in this seventy-year war, it is a particularly propitious time to revisit the tax arbitrage strategy marketed by the Sam Houston Life Insurance Company and embraced by Karl Knetsch and see what lessons we can draw from the Court's response. The particulars are straight-forward: Knetsch borrowed $4 million at 3.5% interest from the company so he could invest the proceeds, with the same company, in deferred annuity bonds paying 2.5%–although this was a guaranteed loser economically (paying $140,000 to earn $100,000 annually)–Knetsch hoped to turn "pre-tax straw into after-tax gold"[57] by deducting the $140,000[58] while deferring the inclusion of the $100,000 in income. Professor Shaviro gives us a front-row seat at the bench trial in the federal district court, which ultimately agreed with the Service that the transaction lacked any economic substance. After the Ninth Circuit agreed, the issue was joined in the Supreme Court. Professor Shaviro unpacks the parties' arguments in their briefs and during oral argument, leading ultimately to the Court's holding that "there was nothing of substance to be realized by Knetsch from this transaction beyond a tax deduction."[59] Professor Shaviro observes that "*Knetsch* is the principal Supreme Court case standing for the proposition that aggressive tax planning may not be respected for tax purposes unless it meets some minimum standard of economic substance. More specifically, while '[a]ny one may so arrange his affairs that his taxes shall be as low as possible,'[60] such arrangements may be ineffective unless they additionally serve non-tax purposes, have non-tax effects (pertaining, for example, to the risks that the taxpayer bears), and, in the business or investment setting, present some prospect of pre-tax profit."[61] Although the Supreme Court has revisited anti-tax avoidance doctrine only once since *Knetsch* in the

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[54] Page ____ .

[55] 364 U.S. 361 (1960).

[56] Daniel N. Shaviro, *The Story of* Knetsch: *Judicial Doctrines Combating Tax Avoidance*. Indeed, Professor Shaviro's chapter opens by comparing the difficulty of drawing this line to Justice Stewart's famous comment about pornography: "I know it when I see it." Page ____ (quoting Jacobellis v. Ohio, 378 U.S. 184, 197 (1964) (Stewart, J., dissenting)).

[57] Page ____ .

[58] At his 80% tax rate, the deduction generated $110,000 in annual tax savings.

[59] 364 U.S. at 366.

[60] Gregory v. Helvering, 69 F.2d 809, 810 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935).

[61] Page ____ .

much-reviled *Frank Lyon Co. v. United States*,[62] the time may be fast-approaching when the Court feels "called on to supply further guidance."[63]

2. *Institutional Lessons*

The ten archaeological expeditions undertaken in *Tax Stories* also provide fresh insights into the structure of tax litigation. For eighty years, scholars have been critical of the Supreme Court's role as the final arbiter of tax disputes.[64] Various proposals have been made to consolidate tax appeals in a national court of tax appeals, with final resort to the Supreme Court sharply curtailed. A common criticism of these proposals is that the Court hears so few tax cases each year that it lacks the technical expertise to superintend the tax litigation structure. Indeed, the complaint is that the Court often makes a bad situation worse when it does enter a tax fray. For example, Kirk Stark notes that "[t]ax lawyers have derided the Supreme Court, complaining that the Court 'hates tax cases' and generally bungles the tax cases it does hear."[65] *Tax Stories* offers fodder for the critics, as the book is filled with robust criticism of the Court's performance in these tax cases.[66] Although *Welch* (Justice Cardozo)[67] and *INDOPCO* (Justice Blackmun)[68]

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[62] 435 U.S. 561 (1978).

[63] Page ___ .

[64] For influential early articles, see Oscar Bland, *Federal Tax Appeals*, 25 Colum. L. Rev. 1013 (1925); Erwin N. Griswold, *The Need for a Court of Tax Appeals*, 57 Harv. L. Rev. 1153 (1944). A 1975 article lists twenty articles subsequent to Dean Griswold's piece. H. Todd Miller, *A Court of Tax Appeals Revisited*, 85 Yale L.J. 229, 231-32 n.14 (1975). For citations to more recent commentary, see Paul L. Caron, *Tax Myopia, or Mamas Don't Let Your Babies Grow Up To Be Tax Lawyers*, 13 Va. Tax Rev. 517, 582 n.294 (1994). *See also* Steve R. Johnson, *The Phoenix and the Perils of the Second Best: Why Heightened Appellate Deference to Tax Court Decisions is Desirable*, 77 Or. L. Rev. 235, 243-47 (1998).

[65] Kirk J. Stark, *The Unfulfilled Tax Legacy of Justice Robert H. Jackson*, 54 Tax L. Rev. 171, 173 (2001) (quoting Erwin N. Griswold, *Is the Tax Law Going to Seed? Remarks Before the Annual Meeting of the American College of Tax Counsel* (Feb. 5, 1993), in 11 Am. J. Tax Pol'y 1, 7 (1994)). *See also* Charles L.B. Lowndes, *Federal Taxation and the Supreme Court*, 1960 Sup. Ct. Rev. 222, 222 ("It is time to rescue the Supreme Court from federal taxation; it is time to rescue federal taxation from the Supreme Court."); Bernard Wolfman, *The Supreme Court in the* Lyon's *Den: A Failure of Judicial Process*, 66 Cornell L. Rev. 1075, 1099-1100 (1981) ("A Supreme Court opinion ought not become the basis for tax lawyers to make a laughingstock of the Court as they now do . . . . It is too much, if not wrong, to expect the Court to develop an enduring and sophisticated tax jurisprudence. In an environment of infinitely diverse and complex transactions governed by an arcane Code, the Court cannot devote the time necessary to become expert.").

[66] For critiques of individual Justices' performance in tax cases, see Stephen B. Cohen, *Thurgood Marshall: Tax Lawyer*, 80 Geo. L.J. 2011 (1992); Robert A. Green, *Justice Blackmun's Federal Tax Jurisprudence*, 26 Hastings Const. L.Q. 109 (1998); Darlene Addie Kennedy, *Eschewing the Superlegislative Prerogative: Tax Opinions of Justice Clarence Thomas*, 12 Regent U. L. Rev. 571 (2000); Stark, *supra* note 65; Bernard Wolfman, et al., *The Behavior of Justice Douglas in Federal Tax Cases*, 122 U. Pa. L. Rev. 235 (1973).

[67] Joel Newman criticizes Justice Cardozo's "whining" (page ___) and complains that the opinion offered "scant guidance" (*id*. at ___), "needlessly confused subsequent courts (as well as tax practitioners and students)" (*id*. at ___), and "long ago should have been consigned to the judicial scrap heap" (*id*. at __).

[68] Joseph Bankman calls Justice Blackmun "somewhat of a bumbler, tax-wise," (*id*. at ___), and his opinion "must be seen as a failure" (*id*. at ___).

come in for the most withering criticism, none of the opinions (and their authors) escape unscathed.[69]

Commentators also are critical of the government's performance in litigating tax cases, suggesting in recent years that the government has a "dismal" track record and is often outgunned by taxpayer's counsel.[70] On one hand, the results in the *Tax Stories* cases belie this criticism: the government prevailed in nine of the ten cases in the Supreme Court (after losing four of the cases in the trial court and three of the cases in the courts of appeals):

Prevailing Party in *Tax Stories* Cases			
Case	Trial Court	Court of Appeals	Supreme Court
Glenshaw Glass	Taxpayer	Taxpayer	IRS
Macomber	-	-	Taxpayer
Kirby Lumber	Taxpayer	-	IRS
Davis	Taxpayer	-	IRS
Welch	IRS	IRS	IRS
INDOPCO	IRS	IRS	IRS
Crane	Taxpayer	IRS	IRS
Schlude	IRS	Taxpayer	IRS
Earl	IRS	Taxpayer	IRS
Knetsch	IRS	IRS	IRS

But on the other hand, in many of the *Tax Stories* cases the government prevailed despite flaws in either litigation strategy or performance.[71] In any event, many of the government's victories were pyrrhic ones, resulting in far more tax revenue lost in the application of the rule announced in the given case to future cases involving other taxpayers. For example, the government won the individual tax battle in *Crane* (requiring the taxpayer to include nonrecourse indebtedness in the amount realized in computing gain on the sale of property) but lost the tax shelter war (by permitting the taxpayer to include the nonrecourse indebtedness in the depreciable basis of the property

[69] For example, Marjorie Kornhauser argues that Justice Pitney's opinion in *Macomber* "created confusion for years in many aspects of income tax law (*id*. at ___). Similarly, Deborah Schenk claims that Justice Holmes' opinion in *Kirby Lumber* was "confusing and led to decades of confusion" (*id*. at ___). Karen Brown contends that the result in *Davis*, although "technically correct," "did not have a salutary effect on the development of the tax law" (*id*. at ____) and that Justice Clark's opinion instead led to "complexities and confusion" (*id*. at _____). Russell Osgood characterizes Justice White's opinion in *Schlude* as "lifeless" (*id*. at ___) and bemoans the absence of any "articulable standards" (*id*. at ___).

[70] *See*, *e.g.*, George Guttman, *IRS Averages: Winning Little, Losing Big*, 61 Tax Notes 155, 155 (1993).

[71] See, *e.g.*, Chapter 1, page ____ (calling taxpayer's counsel better advocates than government in *Glenshaw Glass*); Chapter 6, page _____ (criticizing government for litigating case and presenting "one-sided arguments" in *INDOPCO*). In addition, Joseph Dodge offers in Chapter 1 a list of numerous tax cases "that seem to have been lost by the government in the Supreme Court as the result of perfunctory or inadequate advocacy, or over-reaching." *Id*. at ___ .

in the first place). Similarly, although the decoupling of tax from financial accounting generated additional tax revenues on the deduction at issue in *Schlude*, it opened the door to greater revenue losses in the future as tax-GAAP departures evolved into a one-way street. And many of the government's victories came wrapped in judicial opinions spawning such confusion that the government was required to expend considerable time and resources to firmly establish its beachhead.[72]

Conclusion

In the end, the doctrinal and institutional lessons from *Tax Stories* do not paint a pretty picture of our tax system. Given the problematic results in these ten cases, spanning eighty years and drawing the most talented array of lawyers and jurists that our legal system has to offer, perhaps the fault lies not in the performance of these individual participants but in our income tax itself. If "the best and the brightest" of our tax brigades consistently fall short in cases which command their very best efforts in the white-hot spotlight of a Supreme Court case, the view from the trenches of daily tax practice must be even more bleak. Instead of chastising the lawyers and judges for consistently supplying the wrong answers, we should direct our fire at the Congresses and Administrations that created a tax system that inevitably asks the wrong questions. Until fundamental reform of our income tax becomes more than a chimera, *Tax Stories* will remain without a happy ending.

[72] *See supra* notes 66-69 and accompanying text.