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The Disconnect Between Tax Concepts and the World of Fact: State Law as the Gatekeeper

William B. Barker†

I. INTRODUCTION

Income tax in the United States celebrated its one hundredth anniversary in 2013.¹ The legislation’s promise to the American people was that a tax on net income was “in response to the general demand for justice in taxation, and to the long-standing need of an elastic and productive system of revenue.”² Income was chosen as the basis of the system because “[t]he tax upon incomes is levied according to ability to pay, and it would be difficult to devise a tax fairer or cheaper of collection.”³ The effect of income taxation would be to “equalize the tax burden.”⁴

The promise of income taxation depends on its ability to directly grasp the socio-economic conditions of human experience in a way that assesses those essentials necessary for fair and effective income taxation. In most cases, tax law does this effectively. In some cases, however, there is a significant disconnect between the way tax laws assess the factual basis for tax rules and concepts and the way economics or finance would do so. This disconnect may result in an assessment of the fiscal facts of the taxpayer’s activities that is an inaccurate assessment of economic reality. Consequently, this disconnect reduces the scope of income tax law’s charge to assess taxes equitably based on ability to pay. Moreover, the exploitation of this disconnect is the basis for many tax avoidance strategies.

The principle reason behind tax law’s failure to grasp economic reality at times is the primacy of state law, private law, or legal form in the method of the jurist.⁵ The state laws referred to herein are primarily the

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¹. The Income Tax Act was passed pursuant to the authority of the Sixteenth Amendment that gave Congress the power to tax people on their income. U.S. CONST. amend. XVI; see 1913 Income Tax Act, Pub. L. No. 63-16, § II(B), 38 Stat. 114, 167.
². H.R. REP. No. 63-5, at XXXVI (1913).
³. Id. at XXXVII.
⁴. Id.
⁵. Though the distinction is not very important in the United States, many national legal systems distinguish private law, which is concerned with the legal relations of individuals and entities in civil society, and public law, which takes as its subject matter the relationships between individuals.
private law systems of property, contracts, inheritance, and the family. Though the object of income taxation is to tax income, legislatures take many different approaches to the ultimate tax assessment based on the different characteristics of the source\textsuperscript{6} and the unique characteristics of the taxpayers.\textsuperscript{7} This legislative judgment can be based on various shades of economics, justice, and politics, resulting in a legislative determination that these differences exhibit contrasting elements that warrant differences in tax liabilities.\textsuperscript{8} These differences can lead to large variations in tax liabilities.

In order to bridge the gap between tax law and its application, the interpreter must determine (1) the raw facts, (2) the proper characterization of the facts, and (3) the tax meaning of the terms used in the tax act. Private law controls this process in two ways. First, where the words of the statute are common private law terms, tax rules, concepts, and standards are not independently derived and directly applied to the raw facts, but are instead viewed as private law categories. This approach incorporates by reference a complex set of private law facts that are relevant to private law objectives. In other cases, the tax law does not use common private law terms. In these circumstances, though the meaning of tax terms is not controlled by private law meaning, the critical facts of taxation depend upon the legal context of the fiscal and social relations. Limiting tax meaning to private law considerations can, in some cases, distort tax law's complete assessment of the taxpayer's situation. One important reason for this possible distortion is the differences in objectives of the private law and the tax law. Private law's principle purpose is to facilitate and sanction the existing economic and social relations that are normal or typical.\textsuperscript{9} In contrast, tax law's principle purpose is to raise revenue on a fair and efficient basis using a comprehensive approach to


\textsuperscript{7} See, e.g., I.R.C. §§ 63(c)(3), (f)(1)(A), (g), 7703(a) (2012). Congress chooses to tax people in different ways on the basis of their age, providing an extra standard deduction for those 65 and older, and marital status. Id. A different situation is where Congress provides different tax treatment based on the kind of activity the taxpayer is engaged in, as in the case of business as compared with nonbusiness bad debts. Id. § 166.


the totality of the taxpayer’s activity. Where private law purposes differ from the purposes behind tax law, tax law that follows private law characterization may fail its objective.

Because private law establishes a system that makes economic enterprise possible, one ordinarily can presume that taxpayers chose a particular legal form in order to achieve fairly well-understood economic effects. Where legislatures decide to impose different tax consequences on the basis of different economic consequences, it is logical that the legislature would often use a shorthand reference to private law categories due to their usual economic consequences. Sometimes, however, private law can be out of sync with important aspects of economic and social conditions that may be critical to the goals of taxation. After all, private law assessment is only one perspective on human activity. On its own, private law can hardly provide comprehensive knowledge of the full richness of human activity which may be necessary for fair and equitable taxation. Tax interpretation has other non-legal sources of knowledge available which can complete the picture more in accord with policies and goals of tax incidence. In part, these differences in private and tax law’s objectives can be seen by observing how the interpretation and application of tax concepts to the facts of the taxpayer’s situation demonstrates that tax law shifts between accurate and inaccurate depictions of economic conditions. This paper will analyze this phenomenon by exploring the role legal form plays in the cognitive structure, the legal method, and the reasoned explanations of tax law’s interactions with factual conditions. This analysis will show the consequences of shifting between abstract and mediated legal reasoning dependent on legal form and practical and immediate legal reasoning dependent on fact and the interdependence of tax law and socio-economic conditions. Where the legal form created by taxpayers lacks economic or social relevancy, that legal form contradicts the underlying rationale of tax legislation, and it should not be followed blindly. Thus, the disconnect between tax concepts and economic reality is not inevitable. This paper will examine how interpretation in tax law can and does break away from the dominance of private law considerations.

II. THE IMPORTANCE OF PRIVATE LAW IN THE INTERPRETATION OF TAX LAW

Private law in taxation supports the liberal traditional or the right of liberty, that is the liberty of the citizen to be free from an overreaching

government, the freedom of property, and the freedom of contract, by playing two important roles in taxation. The first rests on the assumption that tax law, when it uses terms found in private law, adopts the private law meaning for its terms. The second is the assumption that even where tax law uses terms to directly describe economic or social relations, those relations can only be seen through the context of private law rights and obligations.

A. Assigning Private Law Meaning to Tax Statutes

Everyday life has a legal setting. Private law provides a necessary condition for the existence of civil life. It provides the contractual framework for making exchange relations possible. It provides the rules and conditions for determining property interests in the world's resources. From this, scholars of American tax law like Boris Bittker have concluded that tax terms are almost always "abbreviated references to these substantive rights of private law." This view is supported by the traditional view of tax interpretation in the United States as follows: "it is a settled rule that tax laws are to be strictly construed against the state and in favor of the taxpayer." This doctrine of statutory construction is said to be "founded so firmly on principles of equity and natural justice, as not to admit of reasonable doubt." Consequently, the starting point in interpreting tax legislation is state private law. For example, in Commissioner v. Brown, the Court stated:

The transaction was a sale under local law . . . . "Capital gain" and "capital asset" are creatures of the tax law and the Court has been inclined to give these terms a narrow, rather than a broad, construction. A "sale," however, is a common event in the non-tax world; and since it is used in the Code without limiting definition and without legislative history indicating a contrary result, its common and ordinary meaning should at least be persuasive of its meaning as used in the Internal Revenue Code.

This view is even more forcefully adopted in civil law countries where the judicial view has generally been that "the tax consequences attached to each legal construction of a transaction are the intended tax results for the underlying factual situation." The doctrine adopted by

16. Id. at 569–71 (citation omitted).
17. See Frans Vanistendael, Judicial Interpretation and the Role of Anti-Abuse Provisions in Tax
civil law jurisdictions is understood to be a consequence of the principle of legality, which requires that taxation can only be imposed by statute, and the mandate of the statute must be carried out by strict interpretation.\textsuperscript{18} This exception is in stark contrast to the usual civil law constitutional requirement that specifically prohibits the strict or literal interpretation of law.\textsuperscript{19} This general approach is also adopted in Commonwealth countries\textsuperscript{20} and the United Kingdom.\textsuperscript{21} A United Kingdom court put it this way: "[I]t is not the economic results sought to be obtained by making the expenditure that is determinative of whether the expenditure is deductible or not; it is the legal rights enforceable by the taxpayer that he acquires in return for making it."\textsuperscript{22}

One reason for this conclusion is that private law, like income tax law, in most civil and common law countries, is national law. This leads most courts to conclude that the legislature, which is responsible for both private law and tax law, attaches the same meaning to legal terms used in its tax laws as that found in private law.\textsuperscript{23} The result follows that the private law characterization is the tax law characterization of the facts.\textsuperscript{24}

Thus, most systems rely on only indirect interpretation of social facts. This traditional approach depends on separate, but related, assessments. The first is that there is an infallible inner consistency of the law.\textsuperscript{25} The tax law and private law understanding of the facts must be the same. Second, the private law legal form of the taxpayer’s activity is always an adequate reflection of the taxpayer’s fiscal situation.\textsuperscript{26} Consequently, the private law point of view is always in sync with the objective and accurate assessment of the tax law.\textsuperscript{27}

Indeed, one author has suggested that tax law has a characteristic that separates it from other forms of law, because the central concept of taxation, "income, is a fiction, [a pure invention for income tax legislation], that does not have independent existence in the world of
physical fact or abstract thought."  
When considering law in general, 
the relevant feature of law in general is that there is a symbiosis between law and its subject matter. That is, there is a natural, almost organic, relationship between law and what law is about... the ordinary symbiosis that exists between law and its subject matter is absent from the foundations of income tax law. 

According to this analysis, there is little room for interpreting tax statutes in a way that encompasses a more substantive, purposeful, and economic manner that seeks a direct reading of socio-economic relations. Consequently, tax laws should be interpreted both strictly and formally—grounded in the state law interpretation and characterization of social acts.

Certainly, private law interpretation exists as part of the fundamental ideas and conceptions underlying the legal institution of tax law. Law, in general, explains, guides, and regulates socio-economic intercourse. 

Private law is an essential condition for social existence.

However, this analytical approach divorces the study of tax law from the point of view of civil society. It assumes that tax law exists and can be analyzed apart from its material basis. Tax law is treated as a closed system, and a search for knowledge proceeds through analytical reasoning working entirely within the private law framework. Analytical thought creates a cognitive structure of the legal system or legal method that is independent of actual social conditions. It exists only in the realm of thought. If analytical reasoning exists only in the realm of abstraction, it is divorced from the real-world subject matter of law and frustrates the practical purpose of legal phenomenon, which is to recognize and manipulate real human activity. Where the practical is ignored, tax law fails to bridge the gap between abstract categories and material conditions.

However, if tax law’s categories only weakly (or not at all) grasp socio-economic conditions, tax law will have little or no normative power. Since observation tells us that income tax law is enormously successful, it must, in the main, assess the realities of modern socio-

29. Id. at 113.
30. An example is the allowance of deductions for taxpayers of “all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.” I.R.C. § 162(a) (2014). The Internal Revenue Code (“Code”) allows deductions which are relevant to tax liability because they are subtracted from gross income to determine the taxable base under I.R.C. § 63(a) (2014), interpreted generally as appropriate and useful expenses related to business activities. Ordinarily, though these concepts require interpretation of what an expense is (a payment) and what is a trade or business, taxpayers have little difficulty in knowing what is and in fact deductible under this section in the ordinary case. See e.g., Welch v. Helvering, 290 U.S. 111, 114–15 (1933) (interpretation of the ordinary and necessary requirement). Deductibility also requires consideration of the capitalization requirement under I.R.C. § 263(a) (2014). See e.g., Indopco, Inc. v. Comm’r, 503 U.S. 79, 84–88 (1992) (interpretation of the capitalization requirement).
economic life. Indeed, the reality of the modern income tax is that its influence on human behavior is immense and that it is as much a part of civil existence as the relations of work, production, and consumption. The penetrating statement that there is no such thing as a pretax world captures the critical relationship between income taxation and today’s society.

III. A DIFFERENT ROLE FOR PRIVATE LAW IN INTERPRETATION

The thesis of this paper is that tax law’s grasp of taxpayers’ affairs should not be limited by the point of view of private law. It starts by disputing the view that the concepts of taxation are analytical abstractions without a concrete basis that can only be given content by private law categories. This point will be demonstrated by showing how U.S. tax law has in many cases broken away from an assessment of the tax facts on the basis of private law.31 The result is that a more nuanced approach to taxpayer activities is embedded in U.S. tax interpretation. The importance of the American approach will be illuminated by comparing it to the quite different approaches of other nations.

A. Determining the Scope of Tax Terms That Have Significant Private Law Meaning

The two central notions of income taxation are income and deductions. The idea of income often depends upon the kind of tax system the country has adopted: schedular or global. The United Kingdom presents the best example of an analytical schedular income tax,32 which separates income into its constituent parts, taxing each part separately. In schedular systems, there is no need for a comprehensive concept of income, since each schedule often uses different terms to define its tax base.

The United States adopted a synthetic or global income tax system.33 Global systems begin with a holistic approach to income; income is treated the same no matter its kind or source.34 A global concept of income does present a difficult task. Its notion is to present as a unity many different aspects of socio-economic relations. Like concepts in general, the concept of income must capture the critical essences of different happenings on the basis of the concept’s objective. The process must take us from the most specific, that is that which sets phenomena

31. See infra Part IV.
33. Id.
34. Id.
apart, to the most general, that which makes them similar.

The global and the schedular contrast in the case of the United States and the United Kingdom demonstrates the form-substance problem. Take, for example, the heart of any income tax system, the tax treatment of labor. Labor, which is the most basic human productive activity, is the largest component of the tax base.\textsuperscript{35} In the United Kingdom, Schedule E charges an employee on “emoluments” of an office or employment.\textsuperscript{36} The United Kingdom courts require a direct link between the payment and services rendered.\textsuperscript{37} However, this link must be supported by legal requirements. Consequently, in many cases where payments were made to an employee by employers and others clearly in connection with the employee providing services, the payments were considered as something other than emoluments of employment based on strict legal interpretation of the employment relation.\textsuperscript{38} The consequence is that income that cannot be included as an emolument is not taxed.

In the United States, in contrast, income is not limited to particular sources.\textsuperscript{39} Instead income includes gain in all its forms.\textsuperscript{40} This has in many cases eliminated requirements that income in the employment setting satisfies certain private law requirements of compensation.\textsuperscript{41}

Income tax law’s subject is the socio-economic base of production, distribution, and consumption. Key elements to our understanding of this complex system are money, capital, and value. Central to our understanding of the dynamic movement of goods, services, money, and capital in the creation of value is the notion of exchange. Income’s role is to pierce these relations in order to capture the value created in a society. This value is as real to those in civil society as the means used to acquire such value. Those items included in the concept of income are conceptually derived from an economic understanding.

In other words, why should the point of view of private law be given an absolutely privileged status as compared with the point of view of economics? Reason confirms that limiting tax concepts to an examination of private law form can often distort tax law’s assessment of material conditions. This distorted outcome should be expected due to the difference in objectives of the private law and the tax law.

Private law’s principle purpose is to facilitate and sanction the

\textsuperscript{35} See JONATHAN BERRY FORMAN, MAKING AMERICA WORK 6, 292 n.13 (2006).
\textsuperscript{36} Income and Corporations Tax Act 1988, c. 1, § 19, sch. E (Eng.).
\textsuperscript{38} Id.; see also Pritchard v. Arundale [1971] 1 Ch. 229; Moore v. Griffiths, [1972] 1 W.L.R. 1024 (Ch.).
\textsuperscript{40} See Barker, supra note 32, at 25.
\textsuperscript{41} See Hornung v. Comm’r, 47 T.C. 428 (1967) (football player includes in income car transferred from non-employer as a prize or award).
existing economic and social relations that are normal. People are concerned with the private law characterization of a particular transaction only when it is of importance to establishing or vindicating the rights of the private parties involved.

People pay particular attention to the parties' characterization because the choice of juridical form is within the parties' range of choice, and our assumption is that the parties voluntarily and knowingly willed the legal consequences of the form. In this way, the law provides the foundation upon which commerce is carried out, and its purpose to facilitate this commerce is achieved. Private law views material conditions from the perspective of private interest, which is only one perspective among many.

However, tax law's purpose is not to uphold the validity of socio-economic intercourse, but to determine its significance in the state-mandated assessment of tax liability. The object is the vindication of statutory policies that are the foundation of our free society. In setting out the procedure for determining tax liability, the legislature provides categories to analyze the taxpayer's activities and provides instructions for determining the tax liability. The relevant question is whether Congress means the private law understanding of the terms it uses, or instead means another understanding that in some cases may be at odds with private law. This alternative requires the tax concepts to reflect the actual material conditions of the transaction.

Tax law has developed defenses where taxpayers use legal form in a way that does not reflect actual legal rights and obligations. Though private law usually assesses human activity in an appropriate way from the perspective of the reasons behind private law, this is not always the case. Where the taxpayer does not intend the legal consequences of the legal form she has chosen, tax systems have doctrines like sham, simulation, and abuse of law which change the legal characterization of the taxpayer's acts for tax purposes. A sham transaction is one where the "acts done were intended to give the appearance of creating legal rights different from those actually created." Courts often state that it is not the label the taxpayer has chosen, but the true legal character of the facts of the transaction entered into that is determinative for tax purposes. These analogous doctrines abandon formalism but replace it with a strict and complete legalism that redefines the potential contradiction between form

42. See Farnsworth, supra note 9.
43. See infra Part IV.
44. Sham is an American and Commonwealth doctrine. Simulation and Abuse of Law are civil law doctrines. Each doctrine requires the recharacterization of the transaction where it is found that the taxpayer did not intend the legal consequences of the private law form.
46. See IRC v. Mallaby-Deeley, [1938] 4 All ER 818, 825 (Eng.).
and substance with the more erudite distinction between legal form and legal substance.

Legalism depends on the objective assessment of legal facts and not on the subjective objectives of the taxpayers. A leading English case demonstrates the importance of the dogmatic attention to a legal construction of a taxpayer’s acts. In IRC v. Westminster, the House of Lords sought the proper characterization of the following circumstances. The Duke of Westminster had contractually obligated himself to pay an employee a sum of £1.90 per week for seven years whether or not the employee remained the Duke’s employee. The Duke explained to the employee that even though he was already entitled to £3.00 a week for his services, the Duke expected him to take only the difference of £1.10 per week. The legal form of the contract for £1.90 was that of an annuity that was income to the employee and deductible by the Duke under the general principles of English tax law. Wages, under U.K. tax law, while still taxable to the employee, were not deductible by the Duke because they were not related to a profitmaking activity under any of the schedules.

Though the House of Lords considered all the factors, including the Duke’s letter to his employee stating his expectation as to the employee’s demand of only the net wages, the court’s decision rested on what it called the “true legal construction of the transaction.” Because the Duke was legally bound to pay the “annuity” even if the employee did not work, the transaction was an annuity, not compensation for services. The transaction was not a sham because, even though the Duke’s intention may have been to pay wages in the form of an annuity, and even though that is exactly what transpired, by binding himself to the contract, the Duke’s legal intent coincided with the legal form of the contract. In this case, form was a true manifestation of legal substance, which is the only relevant reality for taxation. Tax law’s scope depends on the genuine legal intent of the actors.

One must acknowledge that private law is part of the actual material conditions of human activity. In private law, we characterize what people do with the categories of private law from the vantage point of private law. This vantage point has its limitations, however. Tax laws should also

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47. [1936] AC 1, 19 T.C. 490 (Eng.).
48. Id. at 497.
49. Id. at 498.
50. Id. at 502.
52. Westminster, AC 1, 19 T.C. at 508.
53. Id.
54. See Front Simco v. M.N.R., [1960] C.T.C. 123 (Eng.) (sham is where the legal effect is different from the form).
characterize what people do from other perspectives because it views human activity with a different purpose and seeks a different kind of knowledge.\textsuperscript{55} This different grasp of socio-economic conditions should more directly capture their significance for tax purposes.

To see this, one should ask, why does the legislature differentiate between types of transactions and provide different tax consequences? There are two general answers. The first is that in some cases the legislature intends that use of particular legal forms will result in tax-advantaged or tax-disadvantaged results. The second is that the legislature recognizes that certain differences in the taxpayer's position warrant different results. However, these considerations do not lead to the conclusion that legal form controls tax outcome or that legal form is the only way to capture the essential differences and similarities that legislatively require different tax results.

While tax is law and legislatures are lawmakers, not all lawmakers are trained in law. It is difficult to presume that formal legal distinctions are the only meaning the lawmakers had in mind, even in nations where the same legislative body is responsible for both tax law and private law. Legislatures include individuals who bring common experience, knowledge, and non-legal models to drafting. Since legislators are not all experts in all the nuances of legal knowledge, interpretation of tax statutes should be freed from the requirement of private law dominance. However, this freedom in interpretation is formally conferred on those who are trained in the law. It should not be surprising that those trained in the law who are charged with carrying out the legislative will would assume tax meaning coincides with legal form or private law meaning. These interpreters are the tax professionals who include the judges, administrators, private counsels and scholars.\textsuperscript{56} It is this group that remains uncomfortable with a scheme that includes points of view of the facts different than that of the private law.

However, this group misses the importance of tax law's relation to taxpayers who must initially interpret tax law by applying its commands to their individual circumstances. In many cases, tax law should be interpreted as being directly aimed at people's experiences. Thus, the characterization of socio-economic conditions by legal form is not the only way.

Tax law often relies on certain characteristics of the taxpayer's affairs that evidence a difference in position that warrants a difference in tax liability. In some cases, the legal consequences of legal form have

\textsuperscript{55} See infra notes 94–99 and accompanying text.

\textsuperscript{56} See Barker, supra note 5, at 723; see also Rodolfo Sacco, Legal Formants: A Dynamic Approach to Comparative Law I, 39 AM. J. COMP. L. 1, 22 (1991).
economic consequences that can be the basis for different tax treatment. In other words, legal characterization is often in sync with economic characterization. It is not the legal differences per se, however, that are usually the legislator’s reasons for different tax treatment, but instead the economic differences. That is the key. Though it is practical in many instances to use private law characterization as tax law meaning, tax concepts are designed to capture relevant economic consequences.

Therefore, tax concepts should always be understood in terms of real economic effects unless the statute indicates exclusive reliance on legal form. In many cases, legal form is used to achieve fairly well-understood economic effects. In these cases, it is practical to rely on legal form as a substitute for an analysis of actual economic effects. Where legal form fails to capture economic conditions, it should not be followed for tax purposes. Legal implications can have certain economic consequences that legislation has targeted for specific tax treatment. Where those legal consequences lack economic relevancy, it should not be presumed that the legislature had them in mind, and they should be ignored.

Though the dominance of legal form is taken for granted in most countries including the United States, the actual experience in the United States is quite different from the result of the rest of the world and indicates a substantial deviation from this view. The actual process of interpretation in many contexts actually follows the suggested reasoning outlined above. One uniquely American reason for this is that in the United States the legal effects of transactions are practically always determined by the private law of the states, rather than that of the federal government. This fact has exerted a unique pressure on U.S. tax jurisprudence. The result has been that U.S. tax law does not exclusively follow state law determinations.

Sometimes in America the statute explicitly provides that the tax law is based on the rights and liabilities provided under state law. Examples include the definition of community income in Section 66(d)(2) and the prohibition of the deduction of any illegal bribe, etc., “under any law of a state (but only if such State law is generally enforced).” In many cases under estate and gift tax law, tax liability is made explicitly dependent on

57. For example, a contract for the lease of property usually reflects the economic exchange of consideration for the use of property and is taxed differently than a contract for the sale of property, which usually reflects the economic exchange of consideration for the ownership of property. In the case of leased payments, the tenant receives a deduction for the expenditure if incurred in a profit-making activity. I.R.C. § 162 (2012). Whereas in the case of a sale the purchaser must capitalize her expenditure. Id. § 263 (2012).

58. See Barker, supra note 5, at 723; see also Sacco, supra note 56, at 22.

59. See BITTKER & MCMAHON, supra note 12, at I-17.


61. Id. § 162(c)(2) (2012).
the nature of property rights defined under state law. Even where federal tax liability turns upon the character of a property interest held under state law, however, "federal authorities are not bound by the determination made of such property interest by a state trial court." Here, the federal interest in getting the tax correct prevails over adjudicated private law property rights.

Other times the tax statute adopts explicitly federal standards. The definition of alimony under Section 71 provides a federal standard that makes any inconsistent state definition irrelevant. Section 642, in fact, uses the word disability in two different fashions, one in terms of a legal disability to alter the terms of a trust under state law, and in another context to define a disability trust as one where the beneficiary has a disability under federal social security law. In other cases, like the case of marriage, state law determinations are modified in order to accomplish a federal tax purpose. Instances of explicit statutory adoption of either a national legal standard in opposition to either the state law standard or a state private law standard are rare, however. In the majority of cases, tax statutes do not explicitly adopt one position or another.

This large grey area has left to the courts and the administration significant discretion in the development of the content of the tax law in America. It has forced American courts to confront traditional thinking on the role of private law where an obvious goal of national tax law is uniformity in treatment. In speaking of Congress' power to tax, the U.S. Supreme Court stated:

The exertion of that power is not subject to state control. It is the will of Congress which controls... in the absence of language evidencing a different purpose, is to be interpreted so as to give a uniform application to a nationwide scheme of taxation. State law may control only when the federal taxing act, by express language or necessary implication,
makes its own operation dependent upon state law.\textsuperscript{71}

The facts in \textit{Burnet v. Harmel}\textsuperscript{72} present a pointed example of a situation in which the Court had to consider the effect of a state classification of an oil severance payment. In that case, the state of Texas classified the payment as a sale of oil, rather than a lease, which was the typical classification of the economic events in other U.S. states.\textsuperscript{73} The Court did not simply adopt a majority rule and rely on the usual state classifications of the facts as leases, but instead carefully considered the different implications of a sale of oil versus a lease, both in their technical sense and as commonly understood.\textsuperscript{74} The Court determined that for federal tax purposes these transactions were to be treated as leases, thus producing ordinary income, rather than sales yielding preferential capital gains.\textsuperscript{75} The Court stated that following the particular law of Texas "would have tended to defeat rather than further the purpose of the Act."\textsuperscript{76}

Similarly, in \textit{Heiner v. Mellon},\textsuperscript{77} the Court required partnership tax principles to apply to a business entity that was classified as a trust under Pennsylvania law.\textsuperscript{78} The federal law interpretation led to the partners being taxed on their distributive share of the income rather than the trust being taxed, even though under state law governing trusts, no distribution of the income could have been made to the partners.\textsuperscript{79} The Court determined this private law liability was irrelevant because the tax law taxed partners on their "distributive share, whether distributed or not," and, presumably, taxation of the partners was appropriate regardless of whether the income was legally allowed to be distributed currently.\textsuperscript{80} In a similar holding, in \textit{Fidelity-Philadelphia Trust Co. v. Commissioner},\textsuperscript{81} the court had to determine what was the correct basis of a remainder in a trust where the Internal Revenue Code ("Code") required an adjustment to basis for depreciation allowed or allowable. The trust had not taken a depreciation deduction because under Pennsylvania law, it was not allowed to.\textsuperscript{82} The court determined that the depreciation deduction and the concomitant reduction in basis was mandatory under federal tax law because "state law cannot be given an effect for tax purposes which

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\item \textsuperscript{71} Burnet v. Harmel, 287 U.S. 103, 110 (1932) (citations omitted), \textit{superseded by statute, I.R.C. § 613A} (2012).
\item \textsuperscript{72} Id. at 105.
\item \textsuperscript{73} \textit{Id.} at 106-08.
\item \textsuperscript{74} \textit{Id.} at 110-11.
\item \textsuperscript{75} \textit{Id.} at 110-11.
\item \textsuperscript{76} \textit{Id.} at 110.
\item \textsuperscript{77} 304 U.S. 271 (1938).
\item \textsuperscript{78} \textit{Id.} at 270.
\item \textsuperscript{79} \textit{Id.} at 280.
\item \textsuperscript{80} \textit{Id.} at 280-81.
\item \textsuperscript{81} 47 F.2d 36 (3d Cir. 1931).
\item \textsuperscript{82} \textit{Id.} at 38.
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\end{footnotesize}
conflicts with the provisions of a federal revenue law," nor can state law deprive a trustee or taxpayer of a deduction he would be entitled to, or deprive the federal government of a tax based on those provisions. These and many other cases have articulated federal standards for tax legislation contrary to state law legal rights after consideration of the objectives of the taxing act.

The stakes can be enormous when giving tax effect to a private law classification. In *Hart v. Commissioner,* the question was whether a taxpayer was entitled to a deduction for interest paid where the taxpayer had given his promissory note to the creditor for the amount due where, under Massachusetts law, "the giving of a note for interest is a discharge of the original obligation and a substitution therefor for a new and different obligation." Though the interest had been paid according to the law of Massachusetts, allowing a deduction according to this private law understanding would have been inconsistent with a tax law understanding of the requirement of payment under the cash method of accounting. Though the rights and liabilities created under private law are part of factual circumstances of a taxpayer, Massachusetts's particular resolution of these obligations turned out to be irrelevant in applying a national standard for income tax accounting that created a general structure for income reporting.

Uniformity as an aim is abstract, formal, and empty, however. It can justify many different uniform results. In aiming at uniformity, American courts have looked more carefully at the intent and purpose of the tax law, and have often interpreted tax concepts in a more substantive, economic manner. Though the result is that the American jurist interprets tax law more substantively than jurists in other countries around the world, there is still a tendency to accept a private law understanding of a tax law concept, even where it promotes tax avoidance.

Although the general bias of lawyers is that the Code rarely uses legal terms in a national uniform sense, there are so many instances of broad, structural national rules that they often go unnoticed. The concept of income is truly a national one, and there have been very few times where

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83. *Id.*
84. *Id.*
85. 54 F.2d 848 (1932).
86. *Id.* at 851.
87. *Id.*
88. *Id.* at 852.
89. *Id.*
90. See, e.g., James v. United States, 366 U.S. 213, 221 (1961) (embezzlement proceeds included in income even though taxpayer had no state property right to the proceeds); Comm'r v. Glenshaw Glass Co., 348 U.S. 426, 431 (1955) (noncompensatory anti-trust damages are income).
91. See BITTKER & McMahan, supra note 12, at 1-19.
the courts have looked to state law for guidance. These principles can be referred to as the common law of taxation. For example, income tax excludes gifts and inheritances of property from the income of the recipient. This characterization also has federal estate and gift tax implications. In both cases of gifts and inheritances, the Supreme Court has considered the exclusions in terms of private law classifications, and in both cases the Court has determined that the terms have a national meaning different from the normal common law meaning.

In Commissioner v. Duberstein, the Court first considered the term "gift" on the basis of general common law legal principles (shared principles of the various states). The Court concluded that the statute did not "use the term 'gift' in the common-law sense," and that a certain transfer, "though a common-law gift, is not necessarily a 'gift' within the meaning of the statute." This led to the Court adopting a uniform national approach.

The Court, however, completely rejected a legalistic approach, whether one based on state law and rights or one based on a legalistic federal composite of those understandings. The Court considered the practical nature of the tax concept and the required approach to the social setting within which the concept must operate. The Court stated:

Decision...must be based ultimately on the application of the...experience with the mainsprings of human conduct to the totality of the facts of each case. The nontechnical nature of the statutory standard, the close relationship of it to the data of practical human experience, and the multiplicity of relevant factual elements, with their various combinations, creating the necessity of ascribing the proper force to each, confirm us in our conclusion that primary weight in this area must be given to the conclusions of the trier of fact.

In some rare cases, the courts adopt sophisticated economic analysis in place of private law characterization. For example, many courts confronted the question of whether "insurance" premiums paid to its wholly owned captive insurance company, either directly, or indirectly through an unrelated insurance company, were deductible premiums for federal tax purposes. According to the decisions of several courts, the

92. Id.
96. Id. at 285.
97. Id.
98. Id.
99. Id. at 289 (emphasis added).
100. 26 U.S.C. § 162 (2012) allows a deduction for all ordinary and necessary expenses incurred in a trade or business. 26 C.F.R. § 1.162-1(a) (2017) provides that “[a]mong the items included in business expenses are...insurance premiums against fire, storm, theft, accident or other similar losses in the case of a business.”
101. See generally William B. Barker, Federal Income Taxation and Captive Insurance, 6 VA.
answer was no.\textsuperscript{102}

In these cases, the taxpayer's principal argument followed the typical formal, legalistic interpretation of tax terms. Tax law provides taxpayers with a deduction for insurance premiums. The arrangements between parents and subsidiaries met all of the requirements of insurance contracts under private law. The insuring companies were duly incorporated insurance companies under private law. In fact, in many cases, the transactions took the form of a primary insurance contract with an unrelated entity (AIG having been a popular choice), with the primary insurer having reinsured most of the risks with the insured's captive insurance company. There was never a doubt that these policies were fully accepted as insurance for state law purposes; nor did the government ever try to contest these legal facts.\textsuperscript{103}

Instead, the government argued that the notion of insurance for federal \textit{income} tax purposes depended on the satisfaction of certain economic principles of insurance. Insurance was a product evidenced by risk transfer and risk distribution.\textsuperscript{104} Risk transfer is the transfer of the financial consequences of the insured loss from the insured to the insurer. On the basis of the fundamental economic reality of the transaction, insuring with one's subsidiary does not transfer the risk. This is because the owner-insured does not truly rid itself of the financial outcome of the losses. Whatever the financial consequences, the corporation bears them through its ownership stake in the captive. The corporation has not truly parted with the premium, nor with the financial consequences of the risks; the true insured, however, has parted with both. Hence, these cases demonstrate how tax law's concepts can overcome legal form for a highly substantive economic analysis of social relations.

Tax legislation's object is to provide standards to assess taxpayers' activities for appropriate taxation. To do this, tax law must fit taxpayers' activities into a conceptual framework. Tax law's conceptual framework is an abstraction of human activity. But invariably tax law's meaning is seen by the jurist in terms of the abstractions of the private law which can be a substantial step removed from material conditions. As the cases have shown, tax avoidance depends upon the assumption that private law reflects the reality that tax legislation aims at. There is little doubt that in

\textsuperscript{102} See, e.g., Avrahami v. Comm'r, Nos. 17594-13, 18274-13, 2017 WL 3610601, at *16 (T.C. Aug. 21, 2017) (denying a deduction for a premium paid to taxpayer's captive insurance company).

\textsuperscript{103} Where the decision is that the premiums are not deductible for federal income tax purposes, the government consistently applies that determination for other tax purposes. For example, the Code imposes an excise tax of four percent on insurance and one percent on reinsurance premiums paid to a foreign insurer for property liability insurance. I.R.C. § 4371 (2012). In a Private Letter Ruling, the Internal Revenue Service concluded that this excise tax is not applicable where a captive arrangement does not create insurance. I.R.S. Priv. Ltr. Rul. 7,904,047 (Oct. 25, 1978).

\textsuperscript{104} Mobil Oil Corp. v. United States, 8 Cl. Ct. 555, 564 (1985).
most cases for most taxpayers, private law accurately reflects the real material conditions of the taxpayer. In some cases, however, private law fails to reflect those conditions. To deal with avoidance in these cases, the statutory concepts must have a direct, unmediated connection with economic and social conditions.

This requires a sensitivity to the goals of private law characterizations and those of tax characterizations. The purpose of contract law, for example, is to help the parties create their own rights and obligations by agreement. A sale is an important concept of private law where property and its title are transferred between a buyer and seller for consideration. Taxation also attributes to sales tax consequences based upon the parties’ agreement as to rights and duties. The normal tax understanding is clearly in accordance with the private law contractual understanding of the transaction. However, in several well-defined areas of the tax law, interpretation of the tax law concludes that the private law created rights and obligations do not adequately reflect the actual economic conditions. For example, where one family member “sells” property to another at a bargain or discounted price, the tax law requires that the transaction be recharacterized as in part a sale and in part a gift and taxed in accordance with these realities. Contract law, however, would describe this transaction as a sale in accordance with the parties’ description.

When an employee buys property from his employer, however, the contractual understanding of sale for a stated consideration is disregarded for tax purposes for a more nuanced economic understanding of the exchange as including elements of compensation for pay that are simply not reflected in the terms of the private law arrangement. As stated above, when a family member “sells” property to a relative, the tax law must make a determination of whether the sale was at a price less than the property’s fair market value. If that is the case, a private law characterization as a sale for a stated consideration is disregarded for a more realistic assessment that the exchange was in fact in part a sale for the stated consideration and in part a gift of the difference in the fair market value of the property and the sale price. An analogous third area is that of a settlement of a debt. There, the satisfaction of a debt for consideration will be examined from an economic point of view to determine whether the debtor fully paid the creditor, or whether the debt

105. See Farnsworth, supra note 9, at 413.
107. See Comm’r v. LoBue, 351 U.S. 243, 247 (1955). These principles were codified. I.R.C. § 83 (codifying that a taxpayer receiving property in connection with the performance of services includes the difference between the fair market value and the purchase price in income).
108. See 26 C.F.R. §§ 1.1001-1(e), 1.1015-4(a)(1). This also applies in the case of a part gift, part sale to a charity.
was partially paid and partially forgiven by the creditor.\textsuperscript{109} Where a debt was partially forgiven, the debt was not paid to that extent,\textsuperscript{110} and that amount is gross income to the debtor subject to the possibility of a special exclusion.\textsuperscript{111} Each of these exceptions requires taxation in accordance with a true economic understanding of the socio-economic relations, which overcomes dogmatic reliance on legal form.

\textit{B. Tax Concepts and Principles Perceived Through the Lens of Private Law}

The previous section's analysis considered those terms of taxation that had significant private law meaning. There, the general interpretive view was that the legislation must have had the private law meaning in consideration when it adopted the same term for tax incidence. It was shown that reliance on private law meaning for tax purposes sometimes leads to an ineffective tax assessment, which becomes more effective using a more direct assessment of socio-economic conditions. Oftentimes, however, tax law uses terms that are not readily translated into private law categories. In such cases, private law can still play a dominating role in providing the framework for tax law's approach to economic and social relations. This section examines how private law rights and obligations mediate tax law meanings.

The challenge to income tax is that income tax and the economic conditions it seeks to harness are reciprocal elements in a complex, and sometimes contradictory, interaction. In contrast, other taxes like sales taxes have the relatively simple focus on one stage of our economy and require the identification of: the parties to a consumer sale; the value of the commodity, which is readily identified by the contract; and the rate, which is supplied by statute. Income taxation, however, deals with every stage of our complex system of production, distribution, and consumption. In accomplishing its task, tax molds and defines notions like labor, capital, and value for both itself and as an essential aspect of socio-economic conditions. The consequence is that few aspects of social life are free from income tax's incidence or influence. The common expression that there is no such thing as a pre-tax world is an affirmation that income tax is as much a part of civil existence as work, production, and consumption.

Words like income, deduction, or realization perform a central role in income tax law, whereas they have little significance in private law. The


\textsuperscript{110} \textit{Preslar}, 167 F.3d at 1330; \textit{Zarin}, 916 F.2d at 112–13.

\textsuperscript{111} See I.R.C. § 61 (2012) (forgiveness of indebtedness is income); I.R.C. § 108 (2012) (certain debt forgiveness is not included in income).
concepts of income and deduction are abstractions of socio-economic conditions that represent a unity of approach to many different aspects of material conditions tied together on the basis of certain essences. Without legal antecedents, these concepts in the tax law are abstractions of material economic and social conditions that are meant to describe those conditions from the point of view of the needs and policies of taxation. The government is not a party to the exchanges occurring, and its purpose in classifying transactions in certain ways is the result of national tax rationales and policies that may not reflect private law rights and obligations.

To what extent should the tax law’s interpretation of socio-economic conditions be understood only in terms of the legal rights and obligations of the socio-economic relations? These rights should have significance if the legal right reflects an aspect of the conditions that provides an assessment that is relevant to the tax law’s purpose. Where the legal right lacks this relevancy, it should not control.

The U.S. Supreme Court examined the relevancy of private rights in a series of cases that dealt with the reach of the concept of income in determining taxability of extorted and embezzled amounts by taxpayers. In Commissioner v. Wilcox, the Supreme Court was presented with the problem of whether an embezzler must include his wrongful appropriations in his gross income. It was not many years before that the Supreme Court had stressed that income meant economic gain, and that “[c]ommon understanding and experience are the touchstones for the interpretation of the revenue laws.” Yet the Court in Wilcox decided that an embezzler did not have income because he had received the money without a colorable legal claim. Because an embezzler has absolutely no legal rights to the funds, the Court reasoned that he had no income. The result was that the legal characterization of his control over the money prevented the embezzler from having economic gain.

This reliance on legal rights was followed by the Supreme Court in the case of an extortionist, but the Court reached a different result. In Rutkin v. United States, the Court distinguished the extortionist from the embezzler in Wilcox on the basis of common law property principles. While the embezzler has no property interest in embezzled funds because his victim is ignorant of the wrongful taking, an extortionist

112. 327 U.S. 404 (1946).
113. Id. at 405.
115. Wilcox, 327 U.S. at 409.
116. Id. at 405.
117. Id. at 408-09.
118. 343 U.S. 130 (1952).
119. See id. at 138.
has a voidable property interest in the proceeds of the illegal act because his victim is an active party to the transfer of the money.120

Though the two decisions stress legal consequences, their views are contradictory. Wilcox stressed the absolute legal requirement to repay the money, which was also the case in Rutkin. Rutkin, however, stressed different legal rights, finding that the extortionist did have a certain legal right to the funds.121 These technical legal niceties, though accurate private law distinctions, may have been relevant to determine the rights of third parties, but had little to do with a tax law's purpose to tax income. Indeed, Rutkin stressed a more economic approach to income where the Court stressed that money "constitutes taxable income when its recipient has such control over it that, as a practical matter, he derives readily realizable economic value from it."122 This economic approach provides a more rational basis for the result than that of the private law rationale.

Shortly after Rutkin, the Court confronted the case of an embezzler a second time in James v. United States.123 Putting to rest the confusion surrounding Wilcox and Rutkin,124 the Court refused to have the tax outcome controlled by private law technicalities.125 Stressing the economic view in Rutkin, the Court ruled that a person was to be taxed on "realizable economic value," and the embezzler had such gain despite the fact that he lacked legal rights to the money.126

James was decided just after the Court had decided Commissioner v. Glenshaw Glass,127 which reiterated the Court's broad approach to income. In deciding James, the Court cited Glenshaw Glass explaining income has been held to encompass "all 'accessions to wealth, clearly realized, and over which the taxpayer[] [has] complete dominion.'"128 Thus, under James, the interpretation of the concept of income that is satisfied by the factors of accessions to wealth and of dominion or control over the thing that constitutes the gain would not in all cases be limited by private law implications. Hence forward, these guides to interpretation would be utilized in assessing socio-economic relations in a direct manner based upon other non-legal perspectives, including practical reason and economics.

120. Id.
121. Id. at 135–36.
122. Id. at 137.
124. Id. at 215, 221.
125. Id. at 216. Referring to the legal distinction between extortion and embezzlement, the Court stated that "[q]uestions of federal income taxation are not determined by such 'attenuated subtleties.'" Id. (quoting Lucas v. Earl, 281 U.S. 111, 114 (1930)).
126. Id. at 219.
IV. THE LIMITATIONS ON THE RELIANCE ON FORMAL LEGAL METHOD FOR TAX LAW: SIMULATION, SHAM, SUBSTANCE OVER FORM, AND ABUSE OF LAW

It is not an exaggeration to remark that the universal starting point for the interpretation of an application of tax legislation is the private law consequences of the social acts of the taxpayer. The legal method of the tax professional takes as a given that the meaning of the categories of tax law is based on the significant legal rights and obligations created by private law, particularly in the area of contract, property, family law, and trusts and estates. Consequently, tax law’s incidence depends on the free choice of private persons to structure their transactions and relationships with other private parties in any way the private law permits. This may lead taxpayers to use a particular legal form to achieve tax results that appear at odds with what would appear to be the normal tax outcome of the taxpayer’s objective.

Throughout the world, tax law has developed similar approaches where taxpayers use legal form in a way that does not reflect the actual legal consequence intended by the parties. Where the taxpayer does not intend the legal consequences of the legal form she has chosen, tax systems have doctrines like simulation and sham. In general, these doctrines change the tax consequences from that which would result from the pure formalistic expression of the taxpayer’s intent to that which results from the taxation of the true legal consequences intended by the taxpayer.

A. Simulation and Sham

The civil law doctrine of simulation permits the government to contest tax law’s reliance on the civil law form of the transaction by submitting evidence showing the “real nature” of the transaction in order to have the transaction recharacterized in accordance with its real nature. The real nature, however, refers to the real legal meaning of the transaction, and not a contrasting economic meaning. The doctrine compares the legal rights and obligations of the legal form with the taxpayer’s legally intended outcome. It is the latter that forms the basis for the tax outcome. The doctrine only applies where the legal instruments are not intended to have their actual legal effect.

129. See infra Part IV.A.
130. See Vanistendael, supra note 17, at 135.
132. Id.
133. Id. The doctrine can also be found in the Netherlands. See Kees van Raad, The Netherlands, in COMPARATIVE INCOME TAXATION 99 (Wolters Kluwer ed., 2004).
Similarly, those systems founded on the common law have adopted an analogous approach based on the notion of sham. The United Kingdom, like the United States, rejects taxation based on legal labels and instead seeks the true legal character of the transaction entered into.\textsuperscript{134} The notion of sham does more than simply reject the discontinuity between legal labels and legal form. Like the doctrine of simulation, United Kingdom courts follow the doctrine that where the “acts done were intended to give the appearance of creating legal rights different from those actually created,”\textsuperscript{135} the law follows the true legal intent of the parties.\textsuperscript{136}

In the United States, the doctrine of sham is part of the overall approach of form and substance, so its parameters as a separate doctrine are not well-defined.\textsuperscript{137} Where the key to tax incidence is the legal relationship between parties, American courts often go “behind the written contract in order to discover the true facts.”\textsuperscript{138} Courts generally express the view that taxation must be in accord with that which the taxpayer has actually done. This is sometimes referred to as sham in fact. It has as its basis a finding that the legal facts embodied in the legal form chosen by the parties did not actually happen,\textsuperscript{139} or that the parties intended an outcome different from that found in the legal documents. Courts tax in accordance with what the taxpayer actually did, not in accordance with the legal rights and obligations set forth in the documents.

The courts’ determinations expose a contradiction between the formal intent of the parties expressed in the contract and the true facts, reality, or substance of what the parties actually intended. In \textit{Knetsch v. United States},\textsuperscript{140} the Court questioned whether there was in reality a “true obligation to pay interest” where the documents clearly set out a debtor-creditor undertaking, and whether an annuity contract was a “fiction.”\textsuperscript{141} The discovery of “reality” requires the fact finder to go outside the four corners of the written contract by placing the undertaking in a broader context.

Extrinsic evidence that leads to a conclusion as to the parties’ true intentions negates the formal intentions of the written documents. One

\textsuperscript{134} IRC v. Mallaby-Deeley, [1938] All ER 818 at 825 (Eng.). See BITTKER & MCMAHON, supra note 12, at i-20 (noting that legal labels are also not conclusive in the United States).

\textsuperscript{135} Snook v. London and W. Riding Invs., Ltd., [1967] 1 All ER 518, 520 (Eng.); see also Cambell Discount, Ltd. v. Bridge [1962] All ER 385, 402 (Eng.).

\textsuperscript{136} See Subart Investments Ltd. v. The Queen, [1984] CTC 294, 84 DTC 6305 (Can.) (outlining Canadian approach).


\textsuperscript{138} Stern v. Comm’r, 137 F.2d 43, 46 (2d Cir. 1943).

\textsuperscript{139} See YIN AND BURKE, supra note 137, at 118.

\textsuperscript{140} 364 U.S. 361 (1960).

\textsuperscript{141} Id. at 366-67.
way of looking at this is that a social or economic perspective supplants a legal perspective for tax purposes. A second assessment is that, like in the case of simulation or United Kingdom sham, the true facts are simply the true legal facts upon which tax liability depends, and that private law characterization still prevails for taxation. This is the best explanation for the doctrine that legal labels are not determinative for tax purposes.\footnote{See THURONYI, supra notes 131–132 and accompanying text.}

The second assessment can be illustrated by the facts of In re Starr v. Commissioner.\footnote{274 F.2d 294 (9th Cir. 1959).} In that case, the taxpayer had contracted for the installation of a sprinkler system.\footnote{Id. at 295.} The agreement was in the form of a lease that called for rent payments for the first five years of $1240 per year, and at the option of the lessee, an additional five years at $32 per year.\footnote{Id.} No provisions for renewal were made after ten years, except that if the lessee did not renew, the lessor had a period of six months to remove the system from the premises.\footnote{Id.}

The lessee deducted the yearly rental payments in accordance with the tax law's treatment of lease payments.\footnote{Id.} The Commissioner, however, contended that the transaction was in substance a sale, which would make the payments nondeductible capital costs.\footnote{Id.} The court agreed with the Commissioner.\footnote{Id. Although the written contract was for a lease of a sprinkler system with the installer retaining ownership, the court concluded that the “practical realities” of this arrangement was to pass title eventually to the “lessee.”\footnote{Id.} This was established, inferentially, by extrinsic evidence to the effect that the removal by the “lessor” was improbable due to the large cost of removal and the negligible salvage value of the system.\footnote{Id.} There was also evidence that, in every other case of similar leases, the installer had never removed the sprinkler system.\footnote{Id.} Since the court concluded that it would stretch credibility that the “lessor” would ever remove the system, the parties must have intended the transfer of ownership.\footnote{Id.} Thus, this legal consequence of the parties' undertaking resulted in a sale.

Is taxation in accordance with the “practical realities” an example of an economic understanding of the facts substituting for a legal one, or is it taxation in accordance with a true assessment of the legal facts

\footnote{In re Starr v. Commissioner, 30 T.C. 856, 862 (1958), rev'd, 274 F.2d 294 (9th Cir. 1959).}
substituting for a false one? The latter, which stresses contract interpretation, fits the process by which the Starr's Estate court found the practical nature of the arrangement and reached its conclusion as to what the parties really intended. In a contract dispute arising in state court, either party might argue that the agreement was different from its written expression. In order to demonstrate this, a party would have to submit evidence extrinsic to the written document to support her construction of the contract. In contract law, this is the domain of the parol evidence rule that sometimes prevents the introduction of this evidence. Indeed, the Starr's Estate court acknowledged that a state court might follow the kind of label the parties gave the transaction. Because the parol evidence rule only applies where the contract is unambiguous, clear, found to be an integrated expression of the entire undertaking by the parties, the rule might not apply here to exclude extrinsic evidence due to the ambiguity created by the absence of a provision on renewal after ten years and the presence of minimal rent for the second five year term. However, the parol evidence rule has, in many instances, not been applied to third parties including the federal government in tax matters. The policy that it would be unfair to a party not to be able to rely on the written expression of the agreement loses its force where the government seeks fair taxation.

The focus of U.S. tax law on taxation in accordance with what the taxpayer actually did emphasizes two different modes of interpretation: taxation based on the true legal intent of the taxpayer, often referred to as sham in fact, and taxation based on the underlying economic facts of the taxpayer's undertaking, which can be referred to as sham in substance, or substance over form. The former, like the doctrine of simulation and the English doctrine of sham, is taxation in accordance with the true legal facts of the taxpayer's activity, rather than taxation in accordance with inaccurate legal labels or written descriptions. As such, it is a rejection of form where the taxpayer never intended its attendant legal

154. See Farnsworth, supra note 9, at 416.
155. In re Starr, 274 F.2d at 294 ("While according to state law the instrument will probably be taken (with the consequent legal incidents) by the name the parties give it . . . .").
156. See Farnsworth, supra note 9, at 416.
158. Id.
159. See generally Nat'l Lead Co. v. Comm'r, 336 F.2d 134 (2d Cir. 1964) (finding that the intercorporate sale of stock had no reality for tax purposes where the seller continued to control the property for fifteen years after the sham sale); see also ACM P'ship v. Comm'r, 157 F.3d 231, 241 n.30 (3d Cir. 1998).
160. As early as 1930, the Supreme Court "recognize[d] the importance of regarding matters of substance and disregarding forms in applying the provisions of the . . . income tax laws." United States v. Phellis, 257 U.S. 156, 168 (1930).
161. See supra notes 135–136 and accompanying text.
consequences. Rather than a rejection of private law interpretation of the facts, it pursues the objective of genuine legal interpretation of private law acts, and, in so doing, it reinforces and revalidates the primacy of the private law assessment of the taxpayers' activities in the interpretation of tax law.

Substance over form (or sham in substance) plays a quite different role in tax jurisprudence. While interpretation still begins with the private law characterization of the facts which the court accepts as the intended legal consequences of the taxpayer, courts chose in certain situations to tax in accordance with a substantive, economic, or social characterization of the facts. The result is that substance dispenses with the legal form for tax purposes.162

However, the quantum leap from the primacy of private law to its negation under the combined doctrines of substance over form and abuse of law in civil law requires not only explanation, but also justification. The first step is to recognize that private law can and does have a different role in the assessment of the facts for tax purposes, which is neither an exclusive nor a mistaken approach when it is inconsistent with a more substantive tax interpretation.

B. The Contrasting Focus of Sham, Substance over Form, and Abuse of Law: An Example

Understanding private law as the gatekeeper to the realm of fact requires an understanding as well of the ways that courts and revenue departments circumvent the gatekeeper. An issue that tested all of these interpretive devices was the captive insurance issue.

An examination of captive insurance lends itself well to exploring the relationships among private law and sham, substance over form, and abuse of law (the civil law concept). A captive insurance company is typically a wholly-owned insurance subsidiary whose primary function is to insure the risks of its parent organization.163

The IRS has in the past spent considerable effort in challenging the propriety of allowing a deduction to affiliate corporations for “premiums” for “insurance” paid to captive insurance companies.164 The purpose of this section is to illustrate the possible approaches that the Service could use.

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163. See generally Barker, supra note 101.
1. Entity Sham

General principles of income taxation treat incorporated entities owned by other corporations as separate taxpayers even where they engage in transactions with related entities. Whatever the purpose for the formation of the entity, "so long as that purpose is the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity." The question of what is a corporation for federal tax purposes, however, is determined under state law.

Corporations can be disregarded as a sham where the corporation does not engage in any activities. A corporate entity is also a sham where the owner ignores the corporation in doing business. In each of these cases, the taxpayer does not intend the legal consequences of the legal form of the business selected. However, only a low level of business activity like following the formalities of corporate governance, borrowing, and opening bank accounts is required to protect a corporation from sham status. Because captive insurance companies engage in a range of activities, they easily meet the formal requirements of separate corporate entity status. Thus, courts have generally held that captive insurance companies were separate corporate entities.

2. Transactional Sham

The focus of transactional sham is on the contract of insurance, and in particular, on its basic structure which is the payment of a premium for insurance coverage. Transactional sham asks whether the taxpayer intended the legal consequences of an insurance transaction, or whether there are facts outside the four corners of the insurance contract that demonstrates a different intent that presents the true facts upon which tax incidence depends.

*F.R. Johnson Products Co. v. Commissioner* illustrates such a disparity between legal form and true intent. In that case, the taxpayer

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170. See, e.g., Taylor v. Comm’r, 445 F.2d 455, 457 (1st Cir. 1971).

171. See Humana Inc. v. Comm’r, 881 F.2d 247, 257 (6th Cir. 1989); Beech Aircraft Corp. v. United States, 797 F.2d 920, 923 (10th Cir. 1986); Rev. Rul. 77-316, 1977-2 C.B. 53.

172. See Rev. Rul. 77-316, 1977-2 C.B. 53 (recognizing the separate legal status of captive insurance companies); see also supra note 113 and accompanying text.

173. See Barker, supra note 101, at 268.

174. 43 T.C.M. (CCH) 705 (T.C. 1982).
obtained health insurance policies from its wholly owned insurance company on behalf of its employees.\textsuperscript{175} The court found that the taxpayer’s captive “never attempted to accumulate the necessary cash reserve to conduct such a business,” which indicated an entity sham.\textsuperscript{176} Additionally, the taxpayer never paid the captive any insurance premiums,\textsuperscript{177} which indicated a transactional sham. The incongruity between the legal form of insurance and the actual conduct of the taxpayer led the court to deny the premium deductions.\textsuperscript{178}

Another example of a transactional sham in captive insurance cases occurred in \textit{Carnation Co. v. Commissioner},\textsuperscript{179} where insurance was obtained first through an unrelated intermediary insurance company (known as a fronting company) which reinsured most of the risk with the taxpayer’s captive. Due to the primary insurer’s concern about the claims-paying capacity of the captive, Carnation agreed to provide additional capital to the captive to fund the claims payments.\textsuperscript{180} Such agreement would indicate that the insured did not really intend the consequences of insurance, which transfers future losses to another in exchange for the premium payment. Supplying the wherewithal to pay one’s own claims is not in accordance with the legal rights of insurance. The court denied the taxpayer’s deduction for the premiums because the reality was not insurance.\textsuperscript{181}

3. Substance Over Form

There comes a point in viewing the tax consequences of taxpayer activities when the tax administration and courts see taxation in accord with the legal form the taxpayer has chosen as raising issues that mock equitable taxation based on the perceived purposes and objectives of the legislation. It is common to resort to the doctrine that aims to understand taxpayers’ acts in terms of what is commonly referred to as economic reality. Simply put, the commonly understood objectives of the legal form the taxpayer has selected do not appear to be consonant with the broader economic reality that the taxpayer has achieved. But it is more than that. It is that the post-tax effect of the private law understanding of the taxpayer’s actions does not appear to be appropriately applied to the post-tax economic reality that was the taxpayer’s true objective.

Substance over form provides that there is a different, non-legal

\begin{footnotesize}
\begin{itemize}
  \item 175. \textit{Id.}
  \item 176. \textit{Id.} at 719.
  \item 177. See \textit{id.}
  \item 178. \textit{Id.}
  \item 179. 71 T.C. 400 (1978), aff’d, 640 F.2d 1010 (9th Cir. 1981).
  \item 180. \textit{Carnation Co. v. Comm’r}, 640 F.2d 1010, 1012 (9th Cir. 1981).
  \item 181. \textit{Id.} at 1013.
\end{itemize}
\end{footnotesize}
characterization of the taxpayer’s acts that is the appropriate characterization for tax purposes. The predicate for the search for economic reality is the inappropriateness of the consequences of the legal form. Substance over form introduces a new factor in the process of interpretation that is the tax outcome of the legal form. In a circular manner, the proper characterization of the activities for tax purposes depends on a subjective determination of the appropriateness of those consequences.

Accordingly, substance over form requires a justification for its use. In some cases, the form will not be followed where there is no purpose for the use of the legal form other than tax avoidance. This is the so-called business purpose test. In other cases, taxation of individual transactions will be abandoned for taxation based on an assessment of the overall result of a series of integrated transactions under the step-transaction doctrine.

The application of substance over form in captive insurance applies neither the step-transaction doctrine nor the business purpose test. Instead of focusing on unjustified tax avoidance, it adopts a more direct economic assessment of the taxation of the transactions over the legal consequences.

Most captive insurance cases presented to the courts are not easily resolved by entity or transactional sham. The circumstances in Mobil Oil Corp. v. United States involved a more sophisticated example of the typical pattern. Mobil set up an insurance subsidiary, GOIC, originally incorporated in the Bahamas to insure foreign and U.S. operations. Though Mobil had experienced insurance personnel working for GOIC and had a long history of self-insuring its U.S. operations, it, like Carnation, chose to use an independent third-party insurance company (“AIRCO”) to issue policies to Mobil’s U.S. corporations. AIRCO reinsured approximately 99% of these risks with GOIC.

The starting point for analysis is that the legal form of the insurance and reinsurance contracts was, in fact, appropriately characterized as insurance under state law for many purposes. One can assume that where Mobil was required to provide proof of insurance for its operations

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184. See infra text accompanying note 189.
185. 8 Cl. Ct. 555 (1985).
186. Id. at 558.
187. Id. at 559.
188. Id. at 561.
189. There are other contexts, however, where captive insurance may not be insurance under the law. See, e.g., Jordan v. Grp. Health Ass’n, 107 F.2d 239, 250–52 (D.C. Cir. 1939) (a group health plan was not considered to be insurance regulated by the D.C. Code because the arrangement lacked risk transfer); Union Labor Life Ins. Co. v. Pireno, 458 U.S. 119, 127–28 (1982) (similar risk characteristics are required for classification as the business of insurance under federal antitrust laws).
under state laws, the states accepted and relied on these contracts at face value. Additionally, AIRCO was obviously an insurance company regulated and taxed as such under state and federal laws. The result is that the parties carefully planned the transactions and the insurance affiliate complied with all of the requirements of sound insurance practice. Consequently, the legal form and the parties' actual conduct were congruent.

Yet, at the same time, there was a different, non-private law perspective that is obvious from examining captive insurance. This perspective simply represents the insured making its own provisions for its risk exposure, which we commonly understand as self-insurance. Mobil's risk managers recognized as much when they noted:

Approaches to insurance can be roughly categorized as outside insurance, self-insurance and non-insurance. Outside insurance, of course, refers to covering insurable risks by paying a premium to a non-affiliated insurance company in return for an agreement that the insurance company will indemnify the insured for losses suffered. Self-insurance is usually handled by setting aside premiums out of current earnings into a reserve for self-insurance; losses are charged against this reserve. Self-insurance can also be worked through an insurance affiliate. Under this system, operating subsidiaries pay premiums to an affiliated insurance company. Non-insurance means that no provision at all is made for the insurable risks concerned.\(^{190}\)

Note the contrast between private law's classification of the transactions as insurance and the financial sector's point of view that captive insurance represented self-insurance. While the deduction of insurance premiums is clearly enumerated in the tax law,\(^{191}\) self-insurance is neither a category of private law nor of tax law because neither is concerned with non-transactions with oneself.\(^{192}\) Neither the tax nor the private law perspective sees a transaction resulting in an expenditure or loss of control over the funds with self-insurance. The private law form of a transaction by a related corporation with a captive insurance company also lacks the elements of an economic transaction, resulting in an

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190. Defendant's Exhibit No. 7, app. 2, at 1, Mobil, 8 Cl. Ct. 555 (No. 358-78) (reprinting Adams, Economics of Self Insurance, in AN INSURANCE PROGRAM FOR MOBIL OVERSEAS (1958)) (copy on file); see Barker, supra note 101, at 284 n. 65.
191. See Treas. Reg. § 1.162-1(a) (1993) ("Among the items included in business expenses are . . . insurance premiums against fire, storm, theft, [and] accident . . .").
192. However, Congress has long provided special treatment for self-insurance. For example, in 1958 Congress passed an amendment to § 1231 of the Internal Revenue Code to provide special tax relief for the self-insured. See Technical Amendments Act of 1958, Pub. L. No. 85-866, § 49(a), 72 Stat. 1606, 1642 (codified as amended at I.R.C. § 1231(a)(4)(C) (2014)). As the Senate Committee on Finance subsequently explained, the 1958 amendment was enacted to benefit business taxpayers who self-insure their business properties. S. Rep. No. 91-552, at 2055-56 (1969), as reprinted in 1969 U.S.C.C.A.N. 2027. Casualty losses on their business properties were excepted from § 1231 (and, thus, are fully deductible against ordinary income) in view of the fact that amounts added to their self-insurance reserves against casualty losses are not deductible, although premiums paid to an outside insurance company for the same purpose by business taxpayers who are not self-insurers are deductible. Id. at 2128.
expenditure and loss of control from the financial view of insurance. Clearly, however, the differing views are in response to different questions.

The tax understanding requires another question to be answered. In order for substance to prevail over private law characterization, for tax purposes, a countervailing financial view of reality must negate a legal view of reality, because the private law view of captive insurance usually categorizes the transaction as insurance provided by insurance companies. Both the private law and the financial understandings present different bona fide views of reality. However, those differing views are in response to different objectives. Tax law must determine which of these views are more relevant to its objective.

Such a perfect contradiction is rare in tax law. The decision for tax law is which view represents the description of the facts that the legislation meant when it provided a deduction for “all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.”193 In general, the courts that have dealt with captive insurance have assumed that Congress required an evaluation of the economic consequences of the captive insurance arrangement.194 These courts have generally found that a critical element of what an insurance product does is transferring the financial consequences of an insured’s losses to another.195 The courts uniformly agreed that a parent corporation did not transfer that risk when the insurer was its subsidiary.196

Most substance over form formulates the issue as a conflict between a private law characterization of the facts and an economic one. Where the government is successful, the legal characterization is found wanting. The captive insurance cases place the conflict in a slightly different light. Both assessments of taxpayer acts have validity in their field. The legal form of insurance provides valid insights as to what third parties and other insurance companies recognize as insurance and reinsurance. Private law understandings are followed for tax purposes in the normal case because they do have the intended economic consequences that are relevant for tax purposes. In captive insurance cases where premiums are paid to wholly-owned insurance affiliates, the courts must take a deeper look by exploring

194. See, e.g., Cloughery Packing Co. v. Comm’r, 811 F.2d 1297, 1305 (9th Cir. 1987).
195. See, e.g., Mobil, 8 Cl. Ct. at 566.
196. See, e.g., Clougherty, 811 F.2d at 1298; Steams-Roger Corp. v. United States, 774 F.2d 414, 417 (10th Cir. 1985); Carnation Co. v. Comm’r, 640 F.2d 1010, 1013 (9th Cir. 1981); Beech Aircraft Corp. v. United States, 797 F.2d 920, 923 (10th Cir. 1986); Mobil, 8 Cl. Ct. at 558; Humana, Inc. v. Comm’r, 881 F.2d 247, 257 (6th Cir. 1989); Aesthesia Serv. Med. Grp., Inc. v. Comm’r, 85 T.C. 1031, 1040–42 (1985); but see Crawford Fitting Co. v. United States, 606 F. Supp. 136, 145 (N.D. Ohio 1985) (finding that the economic risk of loss was shifted to the captive insurance company).
alternative perspectives of reality and consider adopting these economic insights in order to get the facts of taxation right. Otherwise, the purposes behind the tax legislation would be negated in these situations. This emphasizes the point made in the introduction that the private law is not the only area of knowledge available in interpreting taxpayer actions in tax law. In substance over form, the economic analysis does not negate the truth of private law characterization; it instead finds that characterization does not achieve the same purpose as the statute, because private law’s form does not achieve the economic result upon which the deduction is based.

4. The Civil Law and Substance Over Form

In the past, Germany, a civil law jurisdiction, adopted “economic interpretation” of tax laws, which required consideration of “the social viewpoint, the purpose, and the economic significance of the tax laws and the development of the [situation].”197 The objective of the provision was to overrule the excessively restrictive interpretation of the tax laws that had been developed from concepts and categories of tax law based on legal form.198

Economic interpretation in Germany was short-lived, and it is no longer the law.199 Civil law systems, however, do have versions of substance over form which are the venerable doctrines of abuse of or fraud on the law.200 These doctrines differ from simulation and the American doctrines of sham and substance over form, in that they require a malicious or improper motive on the part of the party to achieve legal rights outside the intendment of the civil law form.201 As applied to tax in the Netherlands, for example, the legal form will be set aside where: “[1] tax reduction was the dominant reason for the transaction, [2] the transaction lacks economic effect, and [3] the intended tax consequences violate the intention of the law.”202

After analyzing the U.S. captive insurance cases, one might expect positive responses to all three questions, but that is not the case. In applying this doctrine, a business purpose for the legal form or the undertaking is sufficient to defeat the application of the doctrine. For captive insurance, purposes like better risk management and retaining the

198. Id. at 23 (citing KARL LAURENZ, METHODENLEHRE DER RECHTSSWISSENSCHAFT (1983)).
199. Id.
200. See infra notes 202–208 and accompanying text.
201. See THURONYI, supra note 131, at 157.
202. Id. at 159.
profits that would be earned otherwise by unrelated insurance companies are sufficient. Thus, outside the United States, it is generally accepted that setting up a foreign captive insurance company advances a bona fide purpose. Such business purposes make it virtually impossible to demonstrate that the dominant motive was tax reduction. These business purposes also provide an economic justification for the form that is sufficient, even though it is not the economic effect of risk transfer that is considered necessary by the U.S. courts. Finally, it can be said that the intended tax consequence is in sync with the intendment of allowing deductions for insurance premiums.

In addition, the basis of the doctrine of abuse of the law is that the taxpayer has used a legal form to "reach a factual situation" that could have been reached by a compatible legal form with a different tax incidence that, unlike the chosen form, is in keeping with the legislative purpose. The result is that taxation will be based on "the legal form of the transaction that is appropriate to the legal factual situation." Thus, in order to recharacterize the transaction from the taxpayer’s chosen legal form to the legal form that carries out the legislative intent, similarity in fact is not sufficient. Additionally, the old facts, which include legal rights and obligations, must fit the new legal form. The significant private law implications of captive insurance simply do not fit a legal recharacterization as self-insurance because legally recognized transactions occur between legally recognized entities. Thus, the result of tax following form comes from an inability or an inherent choice that it is not appropriate to seek an economic meaning different from a private law meaning for taxation. This attitude represents a profound difference from American tax law. For these reasons, captive insurance has not been considered impermissible tax avoidance outside the United States.

V. INTERNATIONAL TAX ARBITRAGE: THE SURPRISING CONSEQUENCE OF THE DIFFERING NATIONAL APPROACHES TO PRIVATE LAW MEANING FOR TAXATION

This research has explored the role private law plays in the interpretation of tax statutes in both the common law and the civil law traditions. Though the starting points have been the same, this research

205. Vanistendael, supra note 17, at 138.
206. Id. at 149 (German standard for their version of abuse of legal constitution).
207. Id. at 133.
has articulated many instances of substantial variation in the dominance of legal form in the interpretation of tax statutes. In particular, while the norm is strict interpretation in accordance with legal consequences, some nations, like the United States, have interpreted some categories of tax law more substantively, resulting in a more economic or social understanding of the facts of taxation.

In the domestic context, nations’ differing approaches to interpretation typically achieve consistent results through the equal application of literal or more substantive interpretation to all taxpayers. Coherence in tax results is a product of the matching of expenditure and receipt under uniform characterization. For example, if the tax law characterization is debt, an interest deduction is matched by an interest inclusion. Where there is deviation from this norm, like in the case of deductible interest paid to an exempt charity, or non-deductible (personal) interest paid to a taxable creditor, this is the result of explicit national tax policy applied differently to the parties involved in the same transaction. However, an unintended but clearly foreseeable consequence of different approaches to the tax meaning of transactions and organizations is the effect they have on cross-border transactions.

This is the fertile soil of international tax arbitrage, which exploits the structural discontinuities caused by the different tax treatment by different nations of the same transactions. Such inconsistencies in the treatment of the resulting cash flows can be caused by simple differences in how the tax rules deal with the same legal transactions, different characterization of the transactions by nations’ private law, or different reliance on private law characterizations, in contrast with economic or


210. Id. § 501(a), (c) (tax exemption for certain charities).

211. Id. § 163(h) (denial of deduction for personal interest).

212. In addressing the problem of dual residence companies, the Senate Finance Committee remarked: “The committee does not believe that the United States Senate wittingly agreed to an international tax system where taxpayers making cross-border investments, and only those taxpayers, could reduce or eliminate their U.S. corporate tax through self-help and gain an advantage over U.S. persons who make similar investments.” S. Rep. No. 99-313, at 422 (1986).


214. An example would be the classification of an expenditure as current and deductible in one system and capital and non-deductible in another.

215. See supra notes 74–75 and accompanying text (discussing the different characterizations of sale and lease).

216. Compare, e.g., Hornung v. Commissioner, 47 T.C. 428, 435 (1967) (the fact that an American football player received an award for great achievements in sports from a person who was not his employer was not determinative in finding that the award was income), with Moor v. Griffiths, [1972] 1 W.L.R. 1024, 1034–35 (Ch.). In Moor, an English football player received a bonus from organizations that were not his employer. Moor, 1 W.L.R. at 1027. This was determinative in finding that he did not have income. Id. at 1034–35.
financial characterizations. This Part focuses on the last two causes, by examining the international tax treatment of debt versus equity and lease versus sale.

A. Debt Versus Equity

The distinction between debt and equity is well recognized throughout the world. It refers to a debtor-creditor transaction where the creditor transfers money to a debtor in return for the debtor’s promise to repay the principle with interest in a certain time frame.\(^{217}\) Equity, on the other hand, represents an ownership interest in property or an enterprise.\(^{218}\) Income taxation typically distinguishes these transactions by permitting, in the case of loans, the deduction of the interest expenditure by the debtor and the inclusion in income of the receipt by the creditor.\(^{219}\)

Income generally includes dividends from stock, but now provides rates that differ from those applied to interest.\(^ {220}\) Dividends are not typically deductible by the payor corporation,\(^ {221}\) whereas interest expenditures are.\(^ {222}\)

A cross-border transaction has the distinct possibility of being characterized differently by two or more countries. For example, corporation X resident in country A funds a subsidiary Y resident in country B that is treated as debt in country B, but as equity in country A.\(^ {223}\) This results in an interest deduction in country B and exempt dividend in country A. Alternatively, the dividend, while taxable, would be classified as foreign source income in country A, and would be entitled to an indirect foreign tax credit for the taxes paid by subsidiary Y to country B. In addition, inclusion of the dividend and subsidiary Y’s income for purposes of the dividend gross-up in company X’s foreign tax credit limit could result in a larger foreign tax credit in country A.\(^ {224}\) In many cases, this can result in an elimination of any tax due on the dividend. This results because country B takes the private law debt


\(^{218}\) Id. at 383.


\(^{221}\) Several nations, however, have experimented with alternative corporate-shareholder integration systems that allow a deduction to the corporation for dividends as to permit a reduced corporate rate for profits used to pay dividends. See BEN TERRA & PETER WATEL, EUROPEAN TAX LAW 166–69 (Kluwer 3d ed., 2001).

\(^{222}\) See I.R.C. § 163(a) (2012).

\(^{223}\) See HYBRID MISMATCH ARRANGEMENTS, supra note 219, at 8.

\(^{224}\) Id.
characterization of the loan agreement, whereas country A takes a more substantive view of the distinction between debt and equity for tax purposes. In the United States, for example, private law debt instruments are often classified as equity under a multi-factor test aimed at finding the true nature of an investment that is in the form of debt.

B. Lease, Sale, or Loan

A second common mismatch arrangement is a transaction that takes the legal form of a lease but which can be, in many cases, a transaction that has some of the aspects of a sale or financing arrangement. For example, in a sale lease-back transaction, corporation X transfers an asset to Y as a private law sale and Y leases the property to X for a fair market value rent. In general, most nations accept the tax validity of the independent private law classifications of transaction 1 as a sale and transaction 2 as a lease. However, where the series of transactions provides that X has the right or obligation to repurchase the property after the lease expires, a more substantive approach can end up reclassifying X as the owner, even though Y is a lessee under private law. This can lead to what is referred to as a double-dip lease where the different tax rules of the lessor and lessee's nations permit each to be treated as the owner of the equipment or real property for the allowance of depreciation and characterization of the cash flow. Due to the popularity of exploiting this discontinuity, at least one country, the Republic of Ireland, has designed a flexible regime for capital allowances or depreciation.

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225. This strong attachment to legal form is shown by a United Kingdom case where a pension fund loaned £20 million to an investment company so the investment company could pay the lender £20 million interest that it already owed. Even though it was unlikely that the investment company could repay the loan, it was still a loan in form, and the payment constituted deductible interest. McNiven v. Westmoreland Inv. Ltd. [1997] STC 1103, 1143-44 (HL U.K.).


227. See, e.g., Frank Lyon Co. v. United States, 435 U.S. 561, 584 (1978) ("[S]o long as the lessor retains significant and genuine attributes of the traditional lessor status, the form of the transaction governs for tax purposes."); see also Leslie Co. v. Comm'r, 539 F.2d 943, 949 (3d Cir. 1976).

228. See, e.g., Frank Lyon Co., 435 U.S. at 584; Leslie Co., 539 F.2d at 949.


230. See Deloitte, Leasing in Ireland Crossing Borders, https://www2.deloitte.com-ie-en/pages/tax/articles/leasing-in-ireland-crossing-borders.html [https://perma.cc/5M49-AX54]. In Ireland, it may be possible for the lessor/owner/financer under private law to claim deductions for capital allowances on the basis of either legal or economic ownership of the asset. Id. Ireland, therefore, is a good fit with other jurisdictions to secure the benefits of double-dip cross-border leases. Id.
C. Recharacterizing Private Law Transactions

Throughout the world, tax systems are being challenged and weakened by the proliferation of tax avoidance, both domestically and internationally.\(^{231}\) In many countries, the remedy has been for legislators to enact rules aimed at eliminating tax benefits, known as general anti-avoidance rules ("GAARs"), where the taxpayer’s primary purpose was to obtain a tax benefit.\(^{232}\)

This statutory inadequacy can be explained. The legal method of the tax profession is central to the efficacy of tax planning and tax avoidance. Tax avoidance can be seen to take advantage of the gap between the intent or object of the statute in taxing a particular situation the way it does or the purpose of the statute in giving a particular benefit to the taxpayer, and the tax outcome advanced by the taxpayer.\(^{233}\) Where avoidance succeeds, the judge adopts a tax outcome for the taxpayer based on a possible reading of the statute that can be perceived as conflicting with an interpretation that accords with the statute’s context, intent, and purpose. Literal interpretation of tax statutes is the necessary outcome of a liberal tradition of individual rights that supports the right of taxpayers to plan and avoid taxation.\(^{234}\) Today in America, this dogma is represented by the textualists. It depends upon the inability of tax concepts to intercede directly with material conditions.\(^{235}\)

Despite the dominance of literalism in the judicial method, today legislators and administrators are asking judges more and more to reflect economic reality in their determinations of tax consequences.\(^{236}\) Especially outside the United States, many judges still reject this role, relying instead on the view that a taxpayer who satisfies the private law form referenced by the statute is entitled to the benefit of the plan.\(^{237}\) Even judges in civil law countries who are used to purposive interpretation, gap-filling, and the analogical development of statutes\(^{238}\) that could provide a method for applying substance in tax matters resist the application of these doctrines in tax law, because the idea of an economic meaning to tax terms different from the private law

\(^{231}\) See HYBRID MISMATCH ARRANGEMENTS, supra note 219, at 5.
\(^{232}\) See, e.g., Income Tax Assessment Act of 1936, Part IVA, § 177D.
\(^{234}\) Id. at 237–38.
\(^{237}\) See HUGH J. AULT & BRIAN J. ARNOLD, COMPARATIVE INCOME TAXATION 16 (Australia), 33 (Canada), 131 (United Kingdom) (2d ed., 2004).
\(^{238}\) See Barker, supra note 21, at 870–73.
understanding is contrary to traditional views of the rule of law.\textsuperscript{239} Formal legal transactions that are normally determinative for tax, however, can often present false appearances of the economic and social reality that the tax law seeks to encompass. In these circumstances, the judge reifies tax concepts, treating the private law form as the real thing, as opposed to actual material conditions taxpayers achieve.

Even where judges attempt to apply the statute in accordance with legislative intent, as jurists, their method is chained to private law concepts and methodologies. In order to adopt a non-private law analysis, the judge will attempt to reclassify the taxpayer’s facts by replacing the old legal form with a new legal form that has different tax implications.\textsuperscript{240} For this reason, some European courts require that when the government argues that the legal form does not reflect the taxpayer’s situation, the government must demonstrate that the actual facts satisfy the legal form that the government asserts supports the proper tax analysis.\textsuperscript{241} Courts will not recharacterize the transaction unless the facts clearly fit the new form.

Where substance seeks to prevail over form, the rejected private law form, however, has not lost its claim to be a reflection of reality. Indeed, even if it is not determinative for tax law purposes, it cannot lose its reality for private law purposes. By necessity, the reality of the new legal form is in conflict with the acts of the taxpayer, as seen through the reality of the old legal form. Because legal method lacks a clear rationale for this transformation of taxpayers’ acts, the new form cannot help but be seen as distorting our understanding of the taxpayer’s situation. Where all avenues produce distortions, liberal legal methodology will lead to a finding for the taxpayer supporting clever tax planning and avoidance.

VI. CONCLUSION

It is generally recognized that the judiciary in the United States, led by the U.S. Supreme Court starting in the 1930s, abandoned strict interpretation of tax statutes for a more contextual, purposeful approach,\textsuperscript{242} for the avowed reason that literal interpretation “would often defeat the object intended to be accomplished.”\textsuperscript{243} The Court remarked that a statute should be interpreted “in accordance with its design and purpose, sacrificing, if necessary, the literal meaning in order that the

\textsuperscript{239} See AULT & ARNOLD, supra note 237, at 50 (France), 69 (Germany), 86 (Japan), 99 (Netherlands), 112 (Sweden).

\textsuperscript{240} The requirement that the facts fit a new legal form which forms the basis of the tax charge is an absolute requirement of anti-avoidance methodology in civil law systems.

\textsuperscript{241} See VANISTENDAEL, supra note 17, at 133, 149.

\textsuperscript{242} See Helvering v. Stockhomes Enskilda Bank, 293 U.S. 84, 93 (1934).

\textsuperscript{243} Helvering v. N.Y. Trust Co., 292 U.S. 455, 464 (1934).
purpose may not fail. Through the time of the Warren Court, American courts in many cases have expanded the reach of income taxation and thwarted tax avoidance.

However, substantial criticism has been aimed at such judicial activism, claiming that many decisions are extra-legal, a usurpation of legislative authority, and are unprincipled and arbitrary for the reason that these decisions abandon the legal certainty provided by interpreting tax law in terms of private law categories and methods. These criticisms have struck a chord with the liberal ideology, which supports the traditional limitations on the judicial method in taxation.

On the surface, the context of this statutory hole is the classic divide between literal (and its modern manifestation—textualism) and purposive interpretation. The formal distinctions between the philosophies can only explain so much, however, because there is an element of literalism in those espousing purposivism and there is an element of purposivism in those espousing literalism. Put practically, there is always some substance to legal form. There is, however, a significant difference in the philosophical approaches by which meaning is assigned to language in the tax act. The history of tax jurisprudence in America shows these significant differences.

Since the days of the Warren Court, the judiciary in America has steadily moved toward a more literalist approach to the interpretation of tax legislation. One consequence of this trend is that the use of dictionary meanings for tax terms has increased exponentially. Tax avoidance's domain is the shadow world that results from the incongruence between statutory language and material conditions. The dictionary meaning of words separated from their tax context and divorced from the legislation's purposes are words without a point of view. They are words that the interpreter can choose any perspective to interpret them from. This focus on dictionary meanings and plain meaning has mystified the real source for meaning in the literal interpretation of tax law, however. This source is private law and legal form.

The very nature of legal method and argumentation, however, places

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244. Id. at 465.
245. See Barker, supra note 21, at 850–59 (discussing the development by the Supreme Court).
246. Id. at 865–66.
248. See Barker, supra note 21, at 830–32, 850–59 (tracing the change from formalism to intentionalism in the U.S. Supreme Court’s approach to interpretation that took place from 1930–1956).
250. See David F. Shores, Textualism and Intentionalism in Tax Litigation, 61 Tax Lawyer 53, 63 (2007).
251. See generally Barker, supra note 233.
private law in between tax law and tax law’s subject matter. The key interconnection between tax law concepts, which are abstractions of social and economic relations, and these conditions of existence become increasingly complicated and hidden by the intermediate abstractions of private law. Where private law form distorts our understanding of the economic base, tax avoiders have a free rein to exploit these anomalies with predictable results. The consequence is an environment rich in avoidance possibilities.

This paper asserts that a justifiable judicial model dealing with tax avoidance in a democratic society can only be developed by liberating tax reasoning from the dominance of private law understandings. This can be done by relegating private law to the status of a factor in assessing the material socio-economic conditions that tax law deals with. In most cases, private law will reflect those real-world conditions as envisioned by the tax law. In other cases, the private law will mask those conditions. The jurist’s role is to see through the private law façade to the actual material conditions.

In these situations, since the statutory concepts must have a direct, unmediated connection with socio-economic conditions, private law characterizations should have little impact on the resolution of the tax issue. That means that the legal method of the tax jurist is not simply to interpret tax concepts through the lens of legal form, but to open up interpretation to knowledge provided by other relevant sciences. In other words, there are other ways to read material conditions for tax law purposes besides those provided by legal form that are necessary in order to understand and apply the science of income taxation.

Proper method views a taxpayer’s situation from many angles, as an individual, a family member, a parent, a worker, a business person, and an investor. These aspects of the human condition require the points of view of economics, finance, law, and even scientific inquiry into personal relationships. Otherwise, limiting tax law’s reading of socio-economic conditions to legal form can be expected to distort, in some cases, tax’s ability to properly assess those conditions in light of the objects and purposes of tax law.