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Edward Yorio

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Dedication

THE BOARD OF EDITORS

OF THE

FORDHAM LAW REVIEW

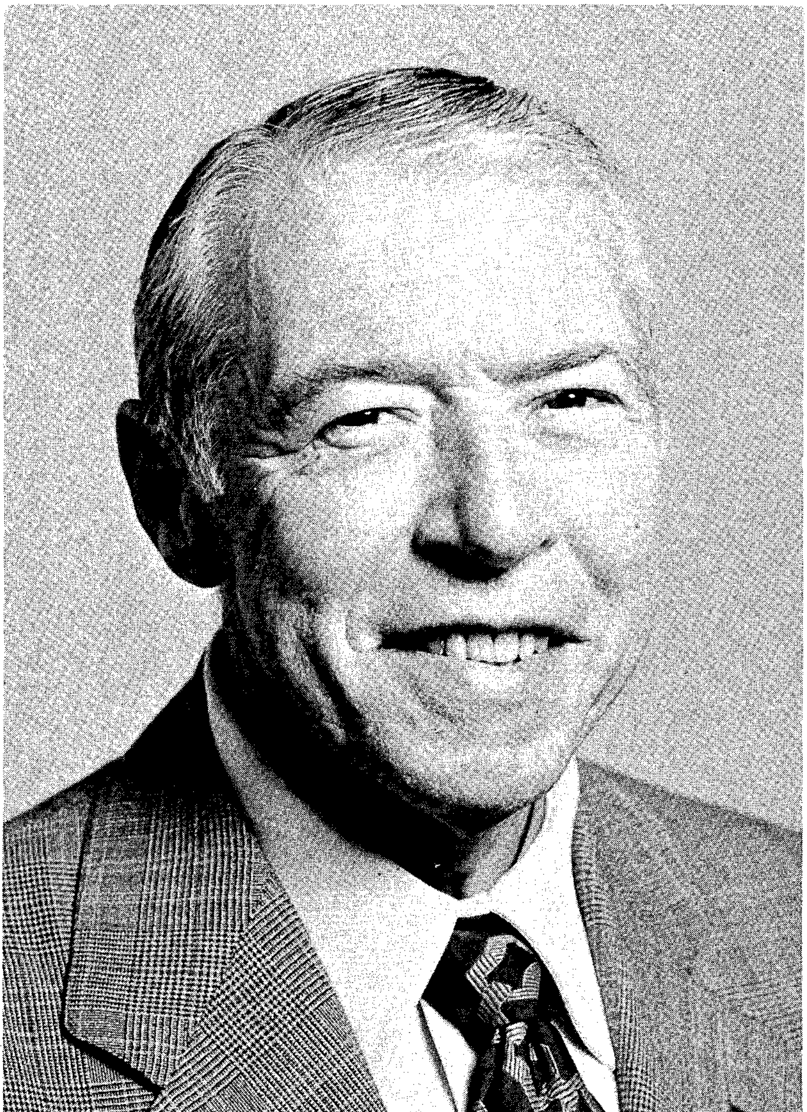
Dedicates Volume LI

to the Memory of

PROFESSOR LEONARD F. MANNING

ALPIN J. CAMERON PROFESSOR OF LAW

Professor Manning served as Faculty Advisor to the Law Review from 1954 to 1983 with unsurpassed distinction. One measure of the man is the measure of those who come to honor him. On the following pages, four Deans of Fordham Law School who served during Professor Manning's tenure pay tribute to him. The Honorable William Hughes Mulligan, former judge of the United States Court of Appeals for the Second Circuit, served as Dean from 1956 to 1971. The Honorable Joseph M. McLaughlin, United States District Court Judge for the Eastern District of New York, was Dean from 1971 to 1981. Professor Joseph M. Perillo, a noted commentator in the field of contracts law, served as Acting Dean from 1981 to 1982. The present Dean, John D. Feerick, took office in 1982. Dean Feerick is well known for his role in the writing and passage of the 25th Amendment to the United States Constitution. As students, both Judge McLaughlin and Dean Feerick served as Editor-in-Chief of the Fordham Law Review under the guidance of Leonard F. Manning.



LEONARD F. MANNING—"BOYS WILL BE BOYS"

I first met Len Manning in the fall of 1939 when we entered Fordham Law School, which was then located in the Woolworth Building, as Morning Division students. Len lived and worked in New Jersey, so I did not get to know him too well in school—only well enough to recognize that he had a quick, penetrating mind and a capacity to express his views on the law or any other subject articulately, on occasion, even passionately.

The times were indeed discouraging. At home, the depression was in full swing. Although nominally full-time students, just about all of our classmates were working in law firms or other related businesses in order to pay a modest tuition and buy an occasional hot meal and a few beers. Abroad, the rumors of war became reality. Hitler had invaded Poland, and early in our third year Pearl Harbor was attacked. Len left school to join the Coast Guard, and eventually served in the Pacific. He took his third year at the Harvard Law School after the war and graduated cum laude. Harvard sensibly gave Len full credit for his Fordham grades, which were excellent.

I joined the faculty in September, 1946 after service in the Army and a brief stint in practice. Len joined us in 1948. We had adjoining offices at 302 Broadway, and despite the limited space, battered furniture and meager paychecks, we were enthusiasts for the School, its students, and our faculty colleagues. Len was and remained throughout his long career at the Law School an intense teacher thoroughly versed in his subject and fully devoted to his students. His particular favorites, of course, were those on the Law Review staff whom he always sought to protect and extol no matter what the circumstance.

When the new building at Lincoln Center was finally occupied, some editors at a late night session, overcome by deadlines and perhaps a few beers, decided to play some baseball in the sparkling new offices. A few windows were cracked and as the new Dean and Warden, I was shocked at the wanton destruction of property—about $10 worth. I remonstrated Len and his answer was simply "Boys Will Be Boys." In fact the players presented him with a trophy consisting of a golden replica of a baseball field with each editor's name engraved at his position. It was entitled simply "Boys Will Be Boys." It was one of Len's proudest possessions, and as time went on I became proud to have played such a villainous role in making it possible.

Len was a loving husband and father, staunchly dedicated to his family. Next to the Law School and the Law Review he was dedicated to Gilbert and Sullivan, the Greek playrights he studied in his Jesuit high school and college days, and Jersey City politics. He was a boon companion, an ardent espouser of causes, and a skilled debater. We, his colleagues of the past, will always remember him with affection and esteem.

HON. WILLIAM HUGHES MULLIGAN

LEONARD F. MANNING—A TRIBUTE

We are given memories so that we may have roses in December. My reminiscences of Leonard Manning date back to 1954 when he was my teacher. There is a short gap between 1959 and 1961, while I fumbled around in the practice of law, and then I came to know Len as a colleague (never quite his equal) on the faculty. The ultimate absurdity, of course, was that I became his titular boss when I became Dean of the Law School in 1971. In all these roles he masked his imposing intellect in the most unassuming demeanor. Truly, he was *suaviter in modo, fortiter in re.**

Len was never a big man. I doubt that he ever had 150 pounds on his five foot seven frame. Yet he commanded a classroom as few others could. Perched on the corner of his desk, he was an exclamation point. With few notes and only the skimpiest of outlines he would sweep across a point, enshrouding it in the case law ("But isn't that the very point of Justice Harlan's concurrence in *Dutton v. Evans*?") and then at the close of the hour, when matters were at their darkest, he would introduce the dawn ("Isn't the test just one of reasonableness? Isn't it all due process?").

His capacity to leap lyrically from case to case was legendary, admired by the well-prepared, equally feared by the unprepared student. A young law student's mind, having been stretched by Professor Manning's questions, never contracted to its original proportions. Yet, he was always gentle. I have never seen or heard of a student who had felt skewered by a Manning attack.

Unlike most other great teachers I have known, Len Manning could also write. My God, could he write! In the early days of the Fordham Law Review when lead articles were hard to find, I served as Editor-in-Chief of the Review. Professor Manning was moderator. Although the second issue of the Volume was already shy an article, I recall how troubled he was by an article we were about to publish on state action and the due process clause.[1] Rather than scotch the article—a power faculty moderators once had—he took pen in hand and, in a matter of ten days, he composed a rebuttal[2] that was as well-written and well-footnoted as any I have ever read.

He had a passion for words. He would go through countless drafts, sifting words and phrases until he had forged the perfect sentence to convey his idea. He was perhaps at his best reviewing the books of those with whom he disagreed. Ever gentle, but still capable of the

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*Smoothly in style, strongly in substance

1. Morse, *Policy and the Fourteenth Amendment: A New Semantics*, 27 Fordham L. Rev. 187 (1958).

2. Manning, *State Responsibility Under the Fourteenth Amendment: An Adherence To Tradition*, 27 Fordham L. Rev. 201 (1958).

rapier thrust, he went after Justice William O. Douglas who had just published *The Right of The People*. Said Manning, ". . . God has given William O. Douglas . . . many gifts. Silence is not one of them."[3]

As did fledgling law teachers in those days, Len Manning taught all over the curriculum. Agency, Introduction to Pleading, Bills and Notes (as it was then known) and several other courses commanded his attention. But it was in Constitutional Law and, to a lesser extent, Conflict of Laws that he finally dedicated his considerable energies. He wrote extensively in both fields and his volume on Church-State Relations,[4] published in 1981 as part of the Nutshell series, has already become a classic.

Apropos classics, Professor Manning attributed much of his analytical skills and writing flair to his classical education. In his nostalgic hours—and at Fordham Law School there seem to be many such hours—he would recall with a fondness approaching reverence his early mentor, Father John Larkin, S.J. It was Father Larkin who, in the grand tradition of the Jesuits, had introduced Len at St. Peter's College to the rhetoric of Cicero, the syllogisms of Aristotle, and the poetry of Catullus. Len never forgot those lessons, and he could drop quotations from ancient Greece and Rome to all who would listen. He was equally at home with Gilbert and Sullivan and his renditions from *Trial By Jury* could be heard by all, whether they would listen or not.

I graduated from the Law School in 1959, and maintained only desultory contact with Len Manning for two years. At that point I received a gracious offer to join the faculty. It was never an aspiration that I had consciously harbored, and I was torn between the rewards of practice and the lure of academic life. Len, who had faced the same dilemma when he was a young associate at Chadbourne, Parke, Whiteside & Wolff, counselled me to accept the offer; and I have never regretted it.

For ten years, as I labored in the vineyards of New York Practice and Evidence, I constantly picked his fertile brain, particularly in matters of jurisdiction. Years before *Shaffer v. Heitner*,[5] he would intimidate me with arguments like, "There is no in personam jurisdiction. There is no in rem. There is only minimum contacts." He could get apoplectic over *Seider v. Roth*.[6] And he went to his grave in the belief that CPLR 1006(g) is unconstitutional. I think he was wrong, but if history is any guide, he will be vindicated.[7]

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3. Book Review, 27 Fordham L. Rev. 141 (1958).
4. L. Manning, The Law of Church-State Relations (1981).
5. 433 U.S. 186 (1977).
6. 17 N.Y.2d 111, 216 N.E.2d 312, 269 N.Y.S.2d 99 (1966).
7. *Cf.* Cordner v. Metropolitan Life Ins. Co., 234 F. Supp. 765, 770 (S.D.N.Y. 1964).

In 1971, I became Dean of the Law School and had to work on a more mundane level with Len, particularly in his capacity as moderator of the Law Review. Not surprisingly, he had difficulties with the notion of a budget. Also not surprisingly, his resourceful mind could find ways to juggle lines to keep the Review solvent. It has been my experience—to paraphrase Lord Acton—that scholarly writing corrupts; and law review writing corrupts absolutely. That was certainly not true of the Fordham Law Review under Len's aegis. He read every article before publication and graced the Review with a felicity of style that became its hallmark during his twenty-eight year stewardship.

No Dean ever had a more loyal faculty member. In matters of principle he was as firm as an oak; in matters of detail, as flexible as a willow. And, as his beau geste, he always let me make the characterization. His early days in Jersey City, the fiefdom of Boss Hague, had instilled in him an appreciation of the need a Dean feels for a reliable vote.

As might be expected, Manning's encyclopedic knowledge of Constitutional Law and his limpid prose style were a magnet to the New York Bar. Briefs came to him in droves, but he took only the most interesting. He wrote a successful brief for the defendants in *Wilder v. Sugarman*,[8] upholding the New York statutes that permit the religious matching of children in their placement away from home. Manning appeared in that case on behalf of ten organizations which included a composite of the largest single Protestant, Jewish and Catholic institutions in the State of New York.

In 1979, he entered *Harris v. McRae*[9] to support the Hyde Amendment limiting the use of federal funds to reimburse the cost of abortions under the Medicaid program. The case was assigned to United States District Judge John Dooling, whose seat I now occupy and at whose desk I am now writing this Tribute. Judge Dooling was unpersuaded by the Manning brief, but it took him 214 pages to say so. The case went directly to the United States Supreme Court[10] where it took the Court only twenty-seven pages to see the wisdom of the Manning approach. He was a great lawyer.

As Edwin Markham wrote at the death of Lincoln, "[A]nd when He fell, in whirlwind He went down; As when a lordly cedar, green with boughs, Goes down with a great shout upon the hills, and leaves a lonesome place against the sky." There is a gaping void at the Law School. It will not soon be filled.

VALE, CARISSIME AMICE!

HON. JOSEPH M. McLAUGHLIN

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8. 385 F. Supp. 1013 (S.D.N.Y. 1974).
9. 491 F. Supp. 630 (E.D.N.Y. 1980).
10. Harris v. McRae, 448 U.S. 297 (1980).

A REMEMBRANCE OF LEONARD F. MANNING

Twenty years ago, almost to the day, I made my first visit to Fordham Law School to be interviewed by Dean William Hughes Mulligan for a position on its faculty. At noon the Dean invited me to join Professor Manning and him for lunch at Henry Stampler's Steakhouse. That lunch is vividly recorded in my memory. The Dean, who had already interviewed me, was mostly silent. Len Manning and myself engaged in a wide-ranging conversation that showed many facets of Len's personality and kaleidoscopic mind. Law, I think was not mentioned. It was only later that I came to know the depth of his legal knowledge and powers of analysis.

I had spent most of the two years preceding the interview in Europe. Len brought me up to date as to what had happened on the Broadway stage and which shows were worth seeing. This was the quintessential Len Manning; friendly and helpful to a stranger while demonstrating the broad spectrum of his interests. I learned of his weekend vacations in the city with his beloved Ceil. I learned the names and characteristics of each of the four sons who were always near the forefront of his thoughts. I am certain that he recited at least one verse of Byron (or was it Gilbert and Sullivan?). Yet, I was being interviewed and he saw to it that I did most of the talking. Skillfully, he drew me out on my professional aspirations, my recent marriage and my literary tastes.

At the beginning of lunch, the Dean had asked if we would have a drink. Len, for what he later told me was the first and last time in his life, ordered sherry. I, as an insecure subject of an interview, followed his lead and also ordered sherry for the first time in my life. The Dean, as was his wont, ordered stronger stuff. Later that afternoon, the Dean told some of the senior faculty that Perillo had interviewed well, "but he drinks sherry." Fortunately for me, in a spasm of tolerance, he overlooked this perception.

The relevance of this anecdote to this memoir of Len Manning is perhaps tangential, but it does illustrate another trait of this delightful friend. He was always doing something for the first time in his life. He thrived on change. He shunned rigidity. As the school changed he oversaw numerous changes in the constitution of the *Law Review*, the number of issues printed and its editorial content. Some of his contributions to the growth of the *Law Review* are detailed in a tribute to him by the editors of Volume 49 of the *Review*.

Although many readers may know Len Manning primarily as moderator of the *Law Review* his main professional interest was the classroom. Before he wrote an article or took on a brief, he would ask, "How will this help me in the classroom?" This is the kind of ethos that has given Fordham Law School a strength that is far greater than one would predict from an analysis of its financial resources. It is an ethos that Len did much to propagate in myself and in others on the faculty.

I have been asked to contribute this remembrance because of my former position as the Law School's Acting Dean. Yet, it is from the perspective of Len Manning as my mentor, my friend, that I compose these words. Since that initial lunch, no social gathering of the Fordham law faculty has or can seem complete to me without a recitation of poetry from Len. Since that initial lunch I can recall no conversation with him where his friendly concern for my well-being was not palpable. As Professor John Calamari wrote while Len was still with us, "[H]e loves everyone with whom he comes into contact. I do not believe that the man has ever harbored an evil or selfish thought. He is a friend *sans pareil*."

PROFESSOR JOSEPH M. PERILLO

IN MEMORIAM: LEONARD F. MANNING*

It is a privilege and honor to deliver these brief remarks in memory of Leonard Manning who had a tremendous impact on many of our lives.

The death of a good person is an occasion, not for mourning, but for celebrating. A life has been completed, a journey finished, a job done. Bishop Fulton J. Sheen has said, "If our lives just 'end,' our friends will ask: 'How much did he leave?' But if our life is 'finished' our friends will ask: 'How much did he take with him?' " What a person takes with him is in direct proportion to what he has given away during his lifetime.

Len Manning was a superb example of a human being who constantly and continually poured himself out for others. Those who have assembled here today know that they contain within themselves a part of him. He gave of himself to help make them what they are. Where might they be today without his encouragement, optimism, concern, enthusiasm, guidance—in a word: LOVE? It is the love of friends such as Len Manning that sustains us and keeps us going in the journey of life.

As today's readings reflect, there is only one law that counts in the long run and that is the law of love. What we sometimes forget when we speak of love is that love costs. It involves sacrifice. To give time, effort and energy to someone is to give up having that time, effort and energy for ourselves and our own pursuits. However, the more we give, the more joy-filled we become. Perhaps that explains Len's contagious cheerfulness and exuberance as well as his pervading optimism and enthusiasm. He was truly spirit-filled—full of the joy of living and giving. I do not think there was ever a person he did not like or for whom he did not have a kind word.

It is not possible in these brief remarks to sum up the life of a man like Len Manning. Generations of Fordham law students have known him as a brilliant teacher and scholar. No person ever loved the students of Fordham Law School more than he did. I can see him now sitting on the classroom desk at 302 Broadway without any notes and with his arms folded across his chest speaking in a relaxed tone about the cases assigned the previous week. He stretched our minds by asking, but never answering, what the cases meant and when we were about to reach a conclusion, he would introduce another element which made the conclusion less clear.

Twenty-eight Boards of Editors of the *Fordham Law Review*—each Board for some strange reason the best ever—have known him as a mentor and advisor who would go to any length for his students. To

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*Eulogy delivered at a Memorial Mass, Church of St. Paul the Apostle, February 1, 1983.

his faculty colleagues he was a cherished friend. But in all things it was Len's humanity that towered over all his accomplishments. Whether arguing a point of law or discussing Gilbert and Sullivan there was a warmth and gentleness that permeated his very being. He was intensely alive. He was a devoted husband and father whose family was at the very center and core of his existence. He would speak with love and pride of the Point Lookout Little League he founded; of the lives and accomplishments of his four boys; of the family trips to the Poconos; and always of his beloved Ceil. Len ended many gatherings with the refrain "Mary C. I Love You."

Although small in physical stature, Len was eager and willing to take on everyone's problems. He was never too busy or tired for a friend whether it was a question of a "parking ticket" or where a son or daughter should go to school. He gave considerable time and energy to civic and charitable activities. He was steadfast in protecting the character of the tiny town in which he spent nearly half his life. He was devoted to his Church, spending endless hours on fund raising and defending federal and state aid to parochial schools. He was a man of the highest integrity and principle, loyal to the ideals ingrained in him by the Jesuits at St. Peter's Prep and St. Peter's College.

It is said that a person is a success if he has "lived well, laughed often and loved much; gained the respect of intelligent men and the love of children; filled his niche and accomplished his task; left the world better than he found it; never lacked appreciation of earth's beauty or failed to express it; looked for the best in others and given the best he had."* Such a man was Len Manning. Len put into life more than he took out and left the world better than he found it. Happy are we who were blessed with the gift of his presence among us! Let us thank God that we were privileged to know him.

DEAN JOHN D. FEERICK

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*B. Anderson, *Success*, in Brown Book Magazine (1904).

FEDERAL INCOME TAX RULEMAKING: AN ECONOMIC APPROACH

*EDWARD YORIO**

INTRODUCTION

DURING the last two decades economic analysis has taken a leading place in the criticism of legal rules[1] with scholars evaluating the rules of such diverse areas as antitrust,[2] contracts[3] and criminal law[4] from the standpoint of economic efficiency.[5] With respect to the federal income tax, however, analysis of the efficiency of applying and administering provisions of the Internal Revenue Code (Code) has played a relatively minor role.[6] The paucity of economic analyses of

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* Professor of Law, Benjamin N. Cardozo School of Law, Yeshiva University; B.A. 1968, Columbia University; J.D. 1971, Harvard University. The author wishes to express his appreciation to Peter Assail, a student at Cardozo Law School, for his research and editorial assistance in the preparation of this Article.

1. Two trailblazing articles were published in the early 1960's. Calabresi, *Some Thoughts on Risk Distribution and the Law of Torts*, 70 Yale L.J. 499 (1961); Coase, *The Problem of Social Cost*, 3 J.L. & Econ. 1 (1960). Since then, the outpouring of scholarly literature has been relentless. Perhaps the most influential, and probably the most cited, books are G. Calabresi, The Costs of Accidents (1970) and R.A. Posner, Economic Analysis of Law (2d ed. 1977).

2. *See, e.g.*, R.A. Posner, Antitrust Law: An Economic Perspective (1976).

3. *See, e.g.*, The Economics of Contract Law (A. Kronman and R. Posner eds. 1979).

4. *See, e.g.*, G. Tullock, The Logic of the Law, 151-249 (1971); Becker, *Crime and Punishment: An Economic Approach*, 76 J. Pol. Econ. 169 (1968).

5. Many scholars have challenged the idea that efficiency should be the primary—or even an important—goal of the legal system. *See, e.g.*, Buchanan, *Good Economics—Bad Law*, 60 Va. L. Rev. 483 (1974); Dworkin, *Is Wealth a Value?*, 9 J. Legal Stud. 191 (1980); Kronman, *Wealth Maximization as a Normative Principle*, 9 J. Legal Stud. 227 (1980); Leff, *Economic Analysis of Law: Some Realism about Nominalism*, 60 Va. L. Rev. 451 (1974); Michelman, *A Comment on Some Uses and Abuses of Economics in Law*, 46 U. Chi. L. Rev. 307 (1979). Professors Calabresi and Posner have responded to this criticism. Calabresi, *About Law and Economics: A Letter to Ronald Dworkin*, 8 Hofstra L. Rev. 553 (1980); Posner, *The Ethical and Political Basis of the Efficiency Norm in Common Law Adjudication*, 8 Hofstra L. Rev. 487 (1980); Posner, *The Value of Wealth: A Comment on Dworkin and Kronman*, 9 J. Legal Stud. 243 (1980). Professor Dworkin has in turn responded to both. Dworkin, *Why Efficiency?*, 8 Hofstra L. Rev. 563 (1980).

6. Only a limited amount of scholarship exists in the area. One book discusses federal income tax simplification in a general way, but with minimal economic analysis. C.H. Gustafson, Federal Income Tax Simplification (1979). Professor Posner devotes a brief section of his book to the federal income tax. R.A. Posner, *supra* note 1, at 371-84. Other works include: G. Tullock, *supra* note 4, at 162-68 (analysis of optimum tax enforcement in dealing with tax evasion); Bittker, *Equity, Efficiency, and Income Tax Theory: Do Misallocations Drive Out Inequities?*, 16 San Diego L. Rev. 735 (1979) (economic misallocations may eliminate inequities in the

income tax rules in both court decisions and legal scholarship should not be surprising. After all, the income tax is designed to accomplish objectives, such as raising revenue,[7] redistributing income[8] and ensuring equal treatment of similarly situated taxpayers,[9] that may conflict with a desideratum of economic efficiency. Moreover, the mandates of a complex, detailed and usually carefully drawn statute like the Internal Revenue Code limit a court's freedom to develop rules that maximize efficiency. In addition, the development of tax law usually reflects an ongoing struggle between taxpayers and the government over externally fixed resources: What one group gains, the other loses.[10] As a consequence, conflicts between taxpayers and the govern-

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federal income tax); Clark, *The Morphogenesis of Subchapter C: An Essay in Statutory Evolution and Reform*, 87 Yale L.J. 90, 93 (1977) (reforms of corporate tax rules would reduce legal costs); Kronman, *Contract Law and Distributive Justice*, 89 Yale L.J. 472, 507-10 (1980) (income tax may be an inefficient method of achieving redistribution); Shavell, *A Note on Efficiency vs. Distributional Equity in Legal Rulemaking; Should Distributional Equity Matter Given Optimal Income Taxation*, 71 Am. Econ. Rev. 414 (1981) (non-tax legal rules ought to be selected on the basis of allocative efficiency, not redistributve effects).

7. If, for example, the maximum marginal income tax rate were 15%, taxpayers would have less incentive to devise plans to avoid the tax. Since the costs of devising these schemes and of legislating and administering against them are high, the federal income tax system would generate lower costs if the maximum rate were 15%, but the price of such efficiency would be a substantial loss in revenue.

8. A proportional tax of 25% might generate as much revenue as the current graduated tax rates and would lower the costs associated with tax-avoidance plans. The price of reducing these transaction costs would be a reduction in the amount of redistribution. Of course, economic analysis may be helpful in determining the most efficient method of achieving a redistributive goal. *See* Kronman, *supra* note 6, at 507-10.

9. If the federal income tax were assessed only on income on which withholding for the tax is practicable, the overall costs of administering the system might be less. But the result of narrowing the tax base to that type of income would be unequal treatment of salaried employees and of those taxpayers not subject to withholding. For a discussion of the trade-off between tax simplification and distributional equity, see Coven, *The Decline and Fall of Taxable Income*, 79 Mich. L. Rev. 1525, 1534-36, 1560-63 (1981).

10. To put it another way, the pattern of development in tax law may not be in accord with a natural selection of Pareto-superior outcomes. An equilibrium state in which some people could be made better off only by making others worse off is called a "Pareto Optimum" state. If one person's situation can be improved without causing a loss to anyone else, a clear societal gain will occur, producing a "Pareto-superior" outcome. *See* J. Hirshleifer, Price Theory and Applications 438-46 (1976). Many primary legal developments seem to conform with the selection of Pareto-superior outcomes. *See, e.g.*, Calabresi & Melamed, *Property Rules, Liability Rules, and Inalienability: One View of the Cathedral*, 85 Harv. L. Rev. 1089, 1094 (1972) (discussion of the efficiency of certain remedies in tort and property law); *infra* sources cited in note 12. This does not appear to be true of developments in federal income tax law, however. *See* Clark, *The Interdisciplinary Study of Legal Evolution*, 90 Yale L.J. 1238, 1255-56 (1981).

ment are likely to produce cumulative complexity of legal rules without offsetting efficiency gains.[11]

Despite these qualifications, this Article argues that efficiency criteria are more relevant to choosing among rules of federal income taxation[12] than has been previously understood.[13] The Article shows how courts should interpret particular provisions of the Internal Revenue Code to achieve its goals most efficiently.[14] Three specific problems in federal income taxation are examined: the definition of a capital asset as it relates to cases in which a taxpayer's motive for holding property has changed over time; the substantiation of deductions and credits; and the meaning of the word "gift." This Article demonstrates that courts have adopted rules in response to each problem that are inefficient, and argues that alternative rules, which are almost certainly more efficient and at least as fair, should have been

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11. *See* Clark, *supra* note 10, at 1255-56.

12. Some scholars have argued that the common law unconsciously and inevitably develops more efficient legal rules. *See, e.g.*, Goodman, *An Economic Theory of the Evolution of Common Law*, 7 J. Legal Stud. 393 (1978); Priest, *The Common Law Process and the Selection of Efficient Rules*, 6 J. Legal Stud. 65 (1977). These evolutionary theories have been challenged, however. *See, e.g.*, Clark, *supra* note 10, at 1265-72; Cooter & Kornhauser, *Can Litigation Improve the Law Without the Help of Judges?*, 9 J. Legal Stud. 139 (1980). In any event, what may be true of common-law rules does not appear to be true of federal income tax rules, which tend to become more complex and less efficient. See *supra* notes 10-11 and accompanying text. Thus, it is necessary to pursue efficiency goals consciously and systematically under the income tax laws rather than rely on an automatic "natural selection" process.

13. This is not to say that economic factors are not now at work, sometimes implicitly, in the income tax system. For example, the annual accounting principle, which in general precludes reopening the return of a prior tax year, has been explained in terms of the needs of practical income tax administration. Burnet v. Sanford & Brooks Co., 282 U.S. 359, 364-65 (1931); Alice Phelan Sullivan Corp. v. United States, 381 F.2d 399, 403 (Ct. Cl. 1967). That imputed income is not taxed under current law is at least partly due to the difficulty of valuing such income. H.C. Simons, Personal Income Taxation 52-53 (1938). The zero bracket amount, I.R.C. § 63 (1976 & Supp. IV 1980), which essentially allows a taxpayer to deduct a flat amount in lieu of itemizing his personal deductions, is defensible in part on the grounds that it minimizes costs in preparing and auditing tax returns. *See* S. Rep. No. 66, 95th Cong., 1st Sess. 5 (1977). For a criticism of the zero bracket amount on the grounds that it unjustifiably sacrifices distributional equity for the sake of income tax simplification, see Coven, *supra* note 9, at 1560-63.

14. This Article accepts, therefore, without making any value judgment, whatever policy underlies a particular statutory provision—be it wealth maximization, raising revenue, equality of tax treatment, or redistribution. The main focus throughout is on the way in which courts can most efficiently carry out the mandate of a statutory provision, not on whether the provision maximizes wealth. This emphasis on process efficiency enables the author to skirt the conflict between the legal economists and their adversaries, *see supra* note 5, because it is unlikely that anyone would challenge the desirability of efficiency in the federal income tax process. *But see* Tullock, *Two Kinds of Legal Efficiency*, 8 Hofstra L. Rev. 659, 659-61 (1980) (poor enforcement may be preferable if law itself is undesirable).

adopted instead.[15] Drawing on this analysis, the Article makes a number of recommendations through which Congress and courts can more generally minimize costs in the formulation, application and administration of the rules of federal income taxation.

I. Sales of Real Estate and the Capital Asset Definition

A. *Outline of the Problem*

Section 1221 of the Code defines the term "capital asset" to mean all "property held by the taxpayer,"[16] excluding, *inter alia*, property held "primarily for sale to customers in the ordinary course of his trade or business."[17] Falling within this exclusion and thus failing to qualify as a capital asset has significant tax consequences:[18] If the property were a capital asset, any gain upon sale would be taxed at a favorable rate, approximately forty percent of the rate on ordinary income.[19] The legislative purpose of reduced taxation of capital gains, as interpreted by the Supreme Court, is to favor " 'appreciation in value accrued over a substantial period of time' " as differentiated from that " 'arising from the everyday operation of a business.' "[20]

The problem of deciding whether to classify a particular asset as a capital asset is complicated when the taxpayer's purpose for owning the asset changes over time. By way of illustration, suppose:

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15. Some of the author's conclusions must remain somewhat tentative in the absence of exhaustive empirical research. See *infra* notes 111-12, 115, 148, 162 and accompanying text. But the empirical evidence that is currently available does support the conclusions in the text. See *infra* notes 31-32, 36, 102, 112, 114, 121, 158-59, 167, 169, 176, 178, 180 and accompanying text.

16. I.R.C. § 1221 (1976).

17. *Id.* § 1221(1). Section 1231(b)(1)(B) of the Code similarly excludes from the definition of "property used in the trade or business" "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business." *Id.* § 1231(b)(1)(B) (1976). Since the language of § 1221(1) and § 1231(b)(1)(B) is identical, whatever is proposed in the remainder of the Article with respect to § 1221(1) is also germane to § 1231(b)(1)(B).

18. But see § 1237(a) of the Code, which provides a safe harbor of capital gain treatment for certain taxpayers.

19. Sixty percent of a taxpayer's net capital gain is deductible from gross income. I.R.C. § 1202(a) (1976). For some taxpayers, capital gains are also subject to the alternative minimum tax. *Id.* § 55(a).

20. Malat v. Riddell, 383 U.S. 569, 572 (1966) (per curiam) (quoting Commissioner v. Gillette Motor Transp. Co., 364 U.S. 130, 134 (1960) and Corn Products Ref. Co. v. Commissioner, 350 U.S. 46, 52 (1955)). Although this may be something of an oversimplification, the Court's distinction is basically valid for the purpose of analysis of the problem considered in this Article. *See* Bernstein, *"Primarily for Sale": A Semantic Snare*, 20 Stan. L. Rev. 1093, 1093 n.1 (1968). For a fuller treatment of this business/investment dichotomy, see Surrey, *Definitional Problems in Capital Gains Taxation*, 69 Harv. L. Rev. 985, 989-99 (1956).

> John Connor bought a forty-eight-acre tract of exurban real estate in 1972 for $10,000. Connor, who thought real estate was the best investment he could make at the time, intended to keep the property at least until he retired. In 1977 he was ready to retire, and he sought a purchaser for the real estate. Although he found a few prospective buyers who were willing to pay about $50,000, he spoke to a local real estate broker who told him that the value of the land was temporarily deflated because high interest costs made it unattractive to developers. The broker advised Connor to subdivide the property into three-acre lots, to improve it with sewers and roads, and to sell the lots to individuals. Connor took the broker's advice, subdivided and substantially improved half of the property in 1977, and sold eight three-acre lots from 1978 through 1981 to purchasers who saw his advertisements in local newspapers. The total proceeds of these sales, net the cost of the improvements, was $45,000. Connor is now seeking a purchaser for the remaining twenty-four-acre tract.

Was the real estate sold by Connor "held primarily for sale to customers in the ordinary course of a trade or business," thereby making the gain from the sale ineligible for capital gains treatment? For the years between 1972 and 1977, the answer is clearly no because during that period Connor held the land as an investment and had no real estate business; after 1977, the answer is less certain.[21] The fairest result, and the result most in accord with the congressional purpose in providing preferential treatment of capital gains, is to allow Connor capital gains treatment on the appreciation in value between 1972 and 1977, but to tax his profits after that date as ordinary income.[22] Although leading scholars[23] and a respected Tax Court judge[24] recognize that this is the proper result in cases involving a change of purpose by the taxpayer, no court has approved bifurcation of the taxpayer's gain into capital gain and ordinary income elements. Instead, courts try to fit the entire gain in a procrustean bed of either capital gain or ordinary income.[25]

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21. See *infra* text accompanying notes 26-35.

22. Connor cannot moor within the safe harbor provided by § 1237(a) of the Code because he substantially improved the property and had not held the tract for ten years before sale. *See* I.R.C. § 1237(a)(2), (b)(3) (1976).

23. 1 S. Surrey, W. Warren, P. McDaniel & H. Ault, Federal Income Taxation 1012 (1972) [hereinafter cited as 1 S. Surrey]; ALI, Definitional Problems in Capital Gains Taxation 33-35, 92-96 (Discussion Draft 1960) (hereinafter cited as "ALI Draft"); Freedman & Solomon, *Tax Consequences on the Sale of Real Estate—A New Approach*, 19 U. So. Calif. Tax Inst. 281, 295 (1967).

24. Bynum v. Commissioner, 46 T.C. 295, 302 (1966) (Tannenwald, J., concurring). *But see* Galena Oaks Corp. v. Scofield, 218 F.2d 217, 220 (5th Cir. 1954).

25. One court specifically rejected a taxpayer's request to bifurcate his gain. Biedenharn Realty Co. v. United States, 526 F.2d 409, 423 (5th Cir.), *cert. denied*, 429 U.S. 819 (1976).

A court today may begin its analysis of Connor's case by stating that whether the property was held primarily for sale to customers in the ordinary course of a trade or business depends upon an evaluation of all the facts.[26] The court may then consider a list of up to nine factors[27] to determine whether the property falls within the exclusion: (1) the purpose of the taxpayer's acquisition of the property; (2) the extent of the taxpayer's sales activity; (3) the frequency, continuity and substantiality of the sales; (4) the extent of subdividing and developing; (5) the use of a business office; (6) the duration of the taxpayer's ownership; (7) the use of real estate brokers to facilitate sales; (8) the substantiality of the income derived from the sales and its percentage of the taxpayer's total income; and (9) the extent of sales promotion activity such as advertising.[28] The court may then assert that none of these factors is "necessarily decisive, and some weigh more heavily than others."[29] Or the court may state that "each case must be decided on its own peculiar facts, and specific factors or combinations of them are not necessarily controlling."[30]

In light of the multitude of relevant criteria,[31] it is difficult to predict how Connor would fare in an attempt to obtain capital gains treatment on the sales.[32] In his favor are the facts that he bought the property and held it for five years as an investment; that he made only

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26. *Id.* at 415; United States v. Burket, 402 F.2d 426, 429 (5th Cir. 1968); Eline Realty Co. v. Commissioner, 35 T.C. 1, 5 (1960).

27. Five factors were considered in Eline Realty Co. v. Commissioner, 35 T.C. 1, 5 (1960); six factors in Howell v. Commissioner, 57 T.C. 546, 554 (1972); seven factors in United States v. Winthrop, 417 F.2d 905, 910 (5th Cir. 1969); and nine factors in Gault v. Commissioner, 332 F.2d 94, 96 (2d Cir. 1964).

28. Factors (1)-(5) are taken from United States v. Winthrop, 417 F.2d 905, 910 (5th Cir. 1969); factor (6) is taken from Howell v. Commissioner, 57 T.C. 546, 554 (1972); factors (6)-(9) are found in Gault v. Commissioner, 332 F.2d 94, 96 (2d Cir. 1964).

29. Gault v. Commissioner, 332 F.2d 94, 96 (2d Cir. 1964).

30. United States v. Burket, 402 F.2d 426, 429 (5th Cir. 1968).

31. The preceding discussion is not even the tip of the iceberg of what courts have said about the § 1221(1) exclusion. The purpose of this Article is not to try to reconcile the judicial pronouncements. At least one court has stated that a reconciliation is impossible: "Over the past 40 years, this case by case approach with its concentration on the facts of each suit has resulted in a collection of decisions not always reconcilable. . . . [E]fforts to distinguish and thereby make consistent the Court's previous holdings must necessarily be 'foreboding and unrewarding.'" Biedenharn Realty Co. v. United States, 526 F.2d 409, 414-15 (5th Cir.) (quoting Thompson v. Commissioner, 322 F.2d 122, 127 (5th Cir. 1963)), *cert. denied*, 429 U.S. 819 (1976). For a fuller discussion and analysis of the case law, see Bernstein, *supra* note 20, at 1098-1109; Freedman & Solomon, *supra* note 23, at 307-56.

32. One commentator offered this advice to lawyers: "If a client asks in any but an extreme case whether, in your opinion, his sale will result in capital gain, your answer should probably be, 'I don't know, and no one else in town can tell you.'" J.L. Wood, Address to the Los Angeles Bar Association Tax Committee (1957), *reprinted in* 35 Taxes 804, 806 (1957).

eight sales during a four year period; that he did not have a real estate office; and that he preferred, and initially tried, to sell to only one purchaser. Against him are the facts that he subdivided and developed half of his holdings;[33] that he pursued a consistent sales program; that he advertised to promote sales; and that his income from the sales was not insubstantial. Many of the factors are offsetting. As a formal matter, the outcome of litigation in this area ostensibly depends on which of the factors the court weighs most heavily.[34] Realistically, the result may often depend on the court's intuitive sense of the merits of the taxpayer's claim.[35]

The present state of the law in this area is a morass of confusion and uncertainty.[36] Whether the courts can devise a workable alternative is another matter. Although a rule of dual treatment is more accurate and more consonant with the underlying purpose of capital gains treatment, even its advocates doubt whether the statute allows it[37] and whether it is administratively feasible.[38] With regard to the latter

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33. Although subdivision and development are not per se fatal, Estate of Barrios v. Commissioner, 265 F.2d 517, 520 (5th Cir. 1959), they can hurt a lot. *See* United States v. Winthrop, 417 F.2d 905, 911 (5th Cir. 1969).

34. *See* Bernstein, *supra* note 20, at 1098-99. In holding for the government in Biedenharn Realty Co. v. United States, 526 F.2d 409 (5th Cir.), *cert. denied*, 429 U.S. 819 (1976), for example, the court heavily weighed the frequency of sales and the taxpayer's activities in improving the property and discounted the taxpayer's prior investment motive. *Id.* at 416-18, 420-22.

35. The classic statement on statutory interpretation by an American realist is Radin, *Statutory Interpretation*, 43 Harv. L. Rev. 863 (1930). When a court in a particularly unsettled area of the law adopts a multifactor balancing test, delicately weighs one factor against another, and then announces the result of this magical and mysterious process, one is reminded of this passage by Professor Radin:

> But since a choice implies motives, it is obvious that, somewhere, somehow, a judge is impelled to make his selection . . . by those psychical elements which make him the kind of person that he is. That this is pure subjectivism . . . is beside the point. It is hard to see how subjectivism can be avoided or how the personality of the judge can be made to count for nothing in his decision on statutory interpretation as on everything else.

Id. at 881; *accord* Llewellyn, *Remarks on the Theory of Appellate Decision and the Rules or Canons about How Statutes are to be Construed*, 3 Vand. L. Rev. 395, 397-400 (1950). For a strong criticism of Radin's position, see Landis, *A Note on "Statutory Interpretation,"* 43 Harv. L. Rev. 886 (1930).

36. "With each court left to its own devices, it was most unlikely that a workable set of general principles would evolve, and they did not." Weithorn, *Subdivisions of Real Estate—"Dealer" v. "Investor" Problem*, 11 Tax. L. Rev. 157, 157 (1956). See *infra* note 114.

37. Bynum v. Commissioner, 46 T.C. 295, 302 (1966) (Tannenwald, J., concurring); 1 S. Surrey, *supra* note 23, at 1012; Freedman & Solomon, *supra* note 23, at 297.

38. "Clearly, this approach [bifurcation] would have its difficulties, such as determining the point of time at which the period of investment is to terminate and then to ascertain the value of the property at that time." 1 S. Surrey, *supra* note 23, at 1012.

issue, this Article demonstrates that the multifactor tests which the courts currently use are themselves extremely costly, and that a dual treatment rule, in addition to producing a more accurate result, is actually a more efficient method of resolving cases that involve a change of purpose by the taxpayer.[39] Before proceeding with this economic analysis, however, it is necessary first to establish that the language and purpose of section 1221(1) allow a court to bifurcate a taxpayer's gain into capital gain and ordinary income.

B. *The Problem of Statutory Construction*

Whether the language or the legislative purpose[40] of section 1221(1) permits a court to bifurcate a taxpayer's gain into capital gain and ordinary income in cases involving a taxpayer change of purpose is a complex question. The language of section 1221(1), taken as a whole,[41] suggests that the principal distinction Congress intended to draw by means of the exclusion was between profits or losses arising from the everyday operations of a business and profits or losses arising from an investment such as stock or real estate.[42] Use of the phrases "inventory," "stock in trade" and "ordinary course of his trade or business" indicates that Congress regards capital asset treatment as inappropriate for assets regularly sold in a business. Conversely, the statute implies that gains on investment property normally merit capital gains treatment.

The legislative history of the clause "property held by the taxpayer primarily for sale to customers in the ordinary course of a trade or business" reinforces the dichotomy between ordinary sales of property in a business and sales of investment property. The clause is the

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39. The author's proposals are not relevant to cases under § 1221(1) that involve a dual purpose or an undecided purpose on the part of the taxpayer. *See* Bernstein, *supra* note 20, at 1102-09.

40. Eminent scholars deny the existence, determinability and relevance of legislative intent or purpose in the interpretation of statutes. *See, e.g.*, Radin, *supra* note 35, at 869-73. But since judicial decisions regularly refer to legislative intent or purpose, as Radin admits, it is important to determine, if possible, the legislative purpose underlying a statutory provision. One distinguished judge regards the discovery of legislative purpose as "one of the surest indexes of a mature and developed jurisprudence." Cabell v. Markham, 148 F.2d 737, 739 (2d Cir.) (L. Hand, J.), *aff'd*, 326 U.S. 404 (1945).

41. For an argument that individual words in the Code should be interpreted in light of the context in which they appear, see Griswold, *Foreword: Of Time and Attitudes—Professor Hart and Judge Arnold*, 74 Harv. L. Rev. 81, 89 (1960) (meaning of the word "gift"). Judge Learned Hand has made the point most eloquently: "[T]he meaning of a sentence may be more than that of the separate words, as a melody is more than the notes, and no degree of particularity can ever obviate recourse to the setting in which all appear, and which all collectively create." Helvering v. Gregory, 69 F.2d 809, 810-11 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935).

42. See *supra* note 20 and accompanying text.

composite result of two amendments that Congress inserted in the exclusion in 1924 and 1934.[43] The earlier amendment was enacted to preclude real estate *dealers* from obtaining capital gains on sales of real estate in the course of a real estate *business*;[44] the later amendment was designed to forestall securities *traders* from receiving ordinary loss treatment on sales of *investments* in stocks or bonds during the Depression.[45] The legislative history thus confirms what the language of the statute suggests, that the purpose of the exclusion is to draw a distinction between business property and investment property, with sales of the former treated as ordinary income (or loss) and sales of the latter treated as capital gain (or loss). The history of the operative clause further suggests that courts are free to use this business versus investment distinction in formulating rules under section 1221(1).[46] One means of buttressing that distinction would be for a court to bifurcate a taxpayer's gain on the sale of subdivided real

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43. Revenue Act of 1934, ch. 277, 48 Stat. 680, 714 (codified at 26 U.S.C. § 1221 (1976)); Revenue Act of 1924, ch. 234, 43 Stat. 253, 263 (codified at 26 U.S.C. § 1221 (1976)). Prior to these amendments, the full text of the provision was:

> (6) The term 'capital assets' as used in this section means property acquired and held by the taxpayer for profit or investment for more than two years (whether or not connected with his trade or business), but does not include property held for the personal use or consumption of the taxpayer or his family, or *stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year.*

Revenue Act of 1921, ch. 136, § 206(a)(6), 42 Stat. 227, 233 (emphasis added).

44. Since real estate dealers were not permitted to inventory real estate held for sale, the pre-1924 exclusion did not apply to real estate held by a dealer for sale. *See* Phipps v. Commissioner, 19 B.T.A. 1293, 1297 (1930), *rev'd on other grounds*, 54 F.2d 469 (2d Cir. 1931); O.D. 848, 4 C.B. 47 (1921). Real estate dealers were thus able to enjoy capital gains treatment on sales of real estate. To eliminate this unintended tax benefit, Congress amended the exclusion to extend to "property held by the taxpayer primarily for sale in the course of his trade or business." Revenue Act of 1924, ch. 234, § 208(a)(8), 43 Stat. 253, 263. The House and Senate reports explained that the purpose of the amendment was "to remove any doubt as to whether property which is held primarily for resale constitutes a capital asset." H.R. Rep. No. 179, 68th Cong., 1st Sess. 19 (1924), *reprinted in* 1939-1, pt. 2, C.B. 241, 255; S. Rep. No. 398, 68th Cong., 1st Sess. 22 (1924), *reprinted in* 1939-1, pt. 2, C.B. 266, 281.

45. The 1934 amendment gave the exclusion its current form: "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business." Revenue Act of 1934, ch. 277, § 117(b), 48 Stat. 680, 714. The addition of the words "to customers" and "ordinary" was designed to prevent stock traders or speculators from claiming ordinary loss deductions on sales of stock or securities. *See* H.R. Rep. No. 1385, 73rd Cong., 2d Sess. 22 (1934), *reprinted in* 1939-1, pt. 2, C.B. 627, 632.

46. As Justice Holmes noted, "The Legislature has the power to decide what the policy of the law shall be, and if it has intimated its will, however indirectly, that will should be recognized and obeyed." Johnson v. United States, 163 F. 30, 32 (1st Cir. 1908).

property between the gain that accrued during an investment period and the gain that accrued after subdivision or development.[47]

Perhaps the strongest objection to a rule of dual treatment is that the language of the Code neither explicitly authorizes, nor implies, that gain be bifurcated. The language of section 1221(1) in fact suggests the opposite: Property seems to be either a capital asset or not a capital asset, but not partially both. Under a literal reading of section 1221(1), therefore, a court might hold that gain could not be bifurcated.[48] Although an exhaustive inquiry into the doctrine of strict construction of statutes is beyond the scope of analysis here,[49] a num-

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47. Arguably, Congress rejected a judicial bifurcation approach when it enacted § 1237 of the Code of 1954. *See* Bernstein, *supra* note 20, at 1110-11. The section grants capital gains treatment (under certain circumstances and to a limited extent) for real property acquired by inheritance or for investment purposes, even though the property is subdivided to facilitate sale. By enacting this safe harbor Congress arguably acknowledged and accepted the rule that treats as ordinary income sales that in the aggregate constitute a course of business at the time of sale, despite the taxpayer's prior investment motive. The Senate Report observed that "an individual who subdivides real property held for investment purposes is likely to be held a dealer and subjected to ordinary income tax rates on the entire long-term gain." S. Rep. No. 1622, 83d Cong., 2d Sess. 115, *reprinted in* 1954 U.S. Code Cong. & Ad. News 4621, 4748 (1954).

Whether the enactment of § 1237 precludes a court from bifurcating a taxpayer's gain under § 1221(1) is doubtful. First, the regulations under § 1237 specifically state that the "rule in section 1237 is not exclusive in its application." Treas. Reg. § 1.1237-1(a)(4)(i) (1960). Second, the enactment of § 1237 indicates that Congress was so concerned about cases that focused solely on the taxpayer's purpose at the time of sale that it enacted a safe harbor to ensure taxpayers a way to avoid those cases. To be sure, Congress would not have enacted § 1237 had the courts regularly bifurcated gain under § 1221(1); § 1237 would have been unnecessary. But the fact that Congress, in enacting § 1237, recognized the unfairness of subjecting to ordinary income tax rates a taxpayer's "entire long-term gain" should encourage courts in a change-of-purpose case to adopt a bifurcation approach that would more generally remedy the unfairness. See *supra* note 46 and accompanying text.

48. For an eloquent judicial statement of the virtues of strict construction, see Gundry v. Pinniger, 1 D.G.M. & G. 502, 505, 42 Eng. Rep. 647, 648 (1852) ("[T]he great cardinal rule is . . . to adhere as closely as possible to the literal meaning of the words. When once you depart from that canon of construction you are launched into a sea of difficulties which it is difficult to fathom.").

49. Dean Pound attacked the doctrine of strict construction in a famous and fascinating historical, political, sociological and legal essay. Pound, *Common Law and Legislation*, 21 Harv. L. Rev. 383 (1908). He summarizes his conclusions about strict construction in this way:

> It is not difficult to show, however, that it is not necessary to and inherent in a legal system; that it is not an ancient and fundamental doctrine of the common law; that it had its origin in archaic notions of interpretation generally, now obsolete, and survived in its present form because of judicial jealousy of the reform movement; and that it is wholly inapplicable to and out of place in American law of today.

Id. at 388. After this Article was written, the author became aware of an important recent contribution to the literature on the role of the judiciary in updating obsolete legislation. *See* G. Calabresi, A Common Law for the Age of Statutes (1982).

ber of arguments suggest that section 1221(1) of the Code need not be construed literally. Strict construction of statutes is most often defended on one of three grounds: (1) It increases certainty in the administration of statutes;[50] (2) it encourages legislative bodies to be more careful and precise in drafting statutory language;[51] or (3) it prevents courts from usurping powers that properly belong to the legislature.[52]

Although certainty may be increased by strictly construing the language of some statutes, absolute certainty is sometimes a vain illusion with even the most detailed and precise statutory language.[53] As Justice Holmes aptly wrote:

> It is not true that in practice (and I know no reason why theory should disagree with the facts) a given word or even a given collocation of words has one meaning and no other. A word generally has several meanings, even in the dictionary. You have to consider the sentence in which it stands to decide which of those meanings it bears in the particular case, and very likely will see that it there has a shade of significance more refined than any given in the wordbook.[54]

Particularly when a statutory provision contains words that are general and open-ended, such as the phrases "primarily for sale" and "ordinary course of his trade or business" in section 1221(1), the interpreter must necessarily exercise discretion in applying the provision.[55]

Empirical confirmation of this point may be found in the evolution of the multifactor test under section 1221(1). In *Malat v. Riddell*,[56] the Supreme Court defined the word "primarily" to mean "of first importance" or "principally."[57] The Court sought to read the statute liter-

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50. Silving, *A Plea for a Law of Interpretation*, 98 U. Pa. L. Rev. 499, 518 (1950).

51. Davies, *The Interpretation of Statutes in the Light of Their Policy by the English Courts*, 35 Colum. L. Rev. 519, 526-27 (1935); Silving, *supra* note 50, at 519.

52. Dickerson, *Statutory Interpretation: A Peek into the Mind and Will of a Legislature*, 50 Ind. L.J. 206, 215 (1975); Frankfurter, *Some Reflections on the Reading of Statutes*, 47 Colum. L. Rev. 527, 545 (1947).

53. *See* Amos, *The Interpretation of Statutes*, 5 Cambridge L.J. 163, 175 (1934); Curtis, *A Better Theory of Legal Interpretation*, 3 Vand. L. Rev. 407, 419-20 (1950).

54. Holmes, *The Theory of Legal Interpretation*, 12 Harv. L. Rev. 417, 417 (1899).

55. Frank, *Words and Music: Some Remarks on Statutory Interpretation*, 47 Colum. L. Rev. 1259, 1265-66 (1947); Radin, *supra* note 35, at 884. Employment of general words may make it possible to adapt a statute to changing social needs. Payne, *The Intention of the Legislature in the Interpretation of Statutes*, 9 Current Legal Prob. 96 (1956).

56. 383 U.S. 569 (1966).

57. *Id.* at 572.

ally and to impose its literal reading on subsequent decisions. Despite this effort, certainty has not been achieved[58] because *Malat* dealt with words and not with the underlying statutory problem.[59] Indeed, the continued ascendancy of nebulous multifactor tests in subsequent cases highlights the failure to achieve certainty by adopting a literal reading of the statutory language.[60]

Other scholars have argued that strict construction serves a normative function.[61] By adhering to a literal reading of statutory provisions, courts supposedly can induce the legislature to be more careful in drafting and enacting statutes in the future.[62] Consequently, the legal system in the long run will function more efficiently and with greater certainty. The price, however, of trying to discipline the legislature in this way is that some litigants may be denied the fairest resolution of their cases. Moreover, legislative revision of a statute is frequently more costly than liberal judicial interpretation to achieve the proper result.[63] Furthermore, because it is in practice difficult, if not impossible, for a legislature to foresee every ramification of a statute,[64] judicial inflexibility for normative reasons in the interpreta-

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58. Justice Frankfurter remarked: "[M]ere reading does not yield meaning. . . . because of the finitude of even the most piercing legislative imagination." Frankfurter, *Foreword—A Symposium on Statutory Construction*, 3 Vand. L. Rev. 365, 367 (1950).

59. As one scholar explained, "In failing to provide any guidance for application of the statutory language to various fact situations, the Supreme Court resolved little and created several new problems." Bernstein, *supra* note 20, at 1109.

60. Subsequent decisions set aside the literalist approach endorsed by the Supreme Court in *Malat. See, e.g.*, Biedenharn Realty Co. v. United States, 526 F.2d 409, 422-23 (5th Cir.), *cert. denied*, 429 U.S. 819 (1976).

61. See *supra* sources cited in note 51.

62. In Justice Frankfurter's words: "Judicial expansion of meaning beyond the limits indicated is reprehensible because it encourages slipshodness in draftsmanship and irresponsibility in legislation." Frankfurter, *supra* note 58, at 368. One senses in Justice Frankfurter's argument the craftsman's pride in his own work and the expectation, even insistence, that others—here the legislature—be equally expert.

63. On the inefficiency of deferring to the legislature, see *infra* text accompanying notes 119-25.

64. Montaigne noted the futility of trying to pass laws governing the infinite variety of human actions:

> What have our legislators gained by selecting a hundred thousand particular cases and actions, and applying a hundred thousand laws to them? This number bears no proportion to the infinite diversity of human actions. Multiplication of our imaginary cases will never equal the variety of the real examples. Add to them a hundred times as many more: and still no future event will be found to correspond so exactly to any one of all the many, many thousands of selected and recorded events that there will not remain some circumstance, some difference, that will require separate consideration in forming a judgment. There is little relation between our actions, which are in perpetual mutation, and fixed and immutable laws.

The Complete Essays of Montaigne, *Of Experience*, 815-16 (D. Frame trans. 1958).

tion of statutes may be unrealistic[65] as well as inefficient. In the specific context of section 1221(1) of the Code, the normative argument has even less merit, for the language of that provision is well suited to the legislative goals of taxing real estate dealers and securities traders in a certain way.[66] A narrow reading of that provision, therefore, will probably not induce Congress to be anymore careful than it actually was.[67]

A third theory invoked to justify strict construction of statutes is the doctrine of separation of powers. According to this theory, a court that construes a statute more broadly than a literal reading of the language allows may be usurping the legislative power of Congress.[68] The scope of the separation of powers doctrine raises issues that are far more complex than analysis here can solve, but a number of arguments suggest that the doctrine should not preclude a court from bifurcating a taxpayer's gain under section 1221(1). It should be noted, preliminarily, that some eminent legal scholars, Professor Radin foremost among them, reject the theory that the separation of powers doctrine restricts the power of courts to interpret a statute broadly.[69] These scholars in fact argue just the opposite: Once a legislature has enacted a statute, the interpretation of the language of the statute belongs to the courts, not the legislature. The statute in a sense takes on life of its own, separate from the will of the legislature.[70] One scholar even suggests that deferring to the legislature after the enactment of the statute may itself violate the separation of powers doctrine by ceding the power of interpretation, which inheres in the judiciary, to the legislature.[71] One judge attacks strict construction on the grounds that it can be used by anti-democratic judges to obstruct the actual, if imperfectly expressed, "democratic will voiced by the legislature."[72]

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65. In the words of Frankfurter, "The imagination which can draw an income tax statute to cover the myriad transactions of a society like ours, capable of producing the necessary revenue without producing a flood of litigation, has not yet revealed itself." Frankfurter, *supra* note 52, at 528.

66. See *supra* notes 43-45 and accompanying text.

67. Professor Griswold noted, "The whole job should not be thrown back onto the draftsmen of the statutes. Their task can be greatly simplified to the benefit of us all by a more sympathetic and organic approach to the problems of construing tax statutes." Griswold, *An Argument Against the Doctrine that Deductions Should Be Narrowly Construed as a Matter of Legislative Grace*, 56 Harv. L. Rev. 1142, 1147 (1943).

68. See *supra* sources cited in note 52. "It is the absence of such a principle [strict construction] which may enlarge the judicial power of interpretation into a virtual power of legislation." Freund, *Interpretation of Statutes*, 65 U. Pa. L. Rev. 207, 213 (1917).

69. Radin, *supra* note 35, at 871-72.

70. *Id.*

71. Freund, *supra* note 68, at 208.

72. Frank, *supra* note 55, at 1262.

Without wholly embracing any of these arguments,[73] one may nevertheless conclude that it would be unwise to use the separation of powers doctrine to justify judicial inflexibility in all cases involving the interpretation of statutes.[74] Dean Pound, in an article otherwise highly skeptical of judicial activism,[75] made these refreshing and enlightening points about the separation of powers doctrine:

> No one will assert at present that the separation of powers is part of the legal order of nature or that it is essential to liberty. We recognize to-day that it is a practical device, existing for practical ends; that it is only the principle of division of labor applied to government, and that it exists in modern states as a mere specialization, for the reason that any function will be better fulfilled by a special organ than by one charged with many functions. It is often better that some other organ perform the special function in single instances, than that it go wholly unperformed. Just as in the organic body, when any one organ fails in its function others are pressed into service to do its work as well as they may, so in the super-organic body politic failure of one organ to do its whole work, or to do it well, puts pressure on the other organs to fill the gap.[76]

Some legal problems, admittedly, should be deferred by courts to the legislature. When, for example, extensive study, research and testimony are necessary to decide an issue properly, Congress is better suited than the courts to gather the relevant data. Similarly, when the resolution of an issue affects the competing interests of social groups that are entitled to input into the process of decision-making, a legislature is usually the more appropriate body to hear all sides of the problem and to promulgate a solution. Further, if a problem demands a speedy and uniform solution, Congress, not the various federal courts, is usually the institution best adapted to meet the challenge.

Whether to bifurcate a taxpayer's gain under section 1221(1) is an issue that involves none of the considerations which favor legislative, rather than judicial, action: The issue neither requires extensive legislative study, nor involves a conflict among competing interest groups, nor requires speed or immediate uniformity. The underlying social policy, which is to afford favored tax treatment to capital gains, has already been resolved by the appropriate government body, the Con-

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73. The views of Professor Radin, for example, have been strongly criticized. Dickerson, *supra* note 52; Landis, *supra* note 35.

74. "The proper office of a judge in statutory interpretation is not . . . the lowly mechanical one implied by orthodox doctrine, but that of a junior partner in the legislative process, a partner empowered and expected within certain limits to exercise a proper discretion as to what the detailed law should be." Payne, *supra* note 55, at 105.

75. Pound, *Spurious Interpretation*, 7 Colum. L. Rev. 379 (1907).

76. *Id.* at 384 (footnote omitted).

gress. The only issue a court need decide in interpreting the definition of a capital asset is under what circumstances, given the parameters of the statutory language, a gain on the sale of property qualifies for reduced taxation.[77]

A number of decisions have endorsed a comparably flexible approach in interpreting the federal income tax statute. In *Corn Products Refining Co. v. Commissioner*,[78] for example, a taxpayer bought and sold corn futures on the commodities exchange. The purpose of the taxpayer's future dealings was to ensure a source of raw material for the company's manufacturing operations at a fixed price. The Court conceded that the futures did "not come within the literal language of the exclusions set out" in what is now section 1221.[79] The Court nevertheless held that the purpose of the capital gains provisions required ordinary income treatment for the company's profits on corn futures because the futures were purchased not for investment, but for business reasons.[80]

More germane to the issue of dual treatment under the section 1221(1) exclusion is the Court's decision in *Helvering v. Owens*,[81] which involved a taxpayer whose automobile, used only for pleasure, had been damaged in a collision. The government, conceding that the taxpayer was entitled to some deduction, disputed only the amount claimed by the taxpayer. The relevant statutory language read: "The basis for determining the amount of deduction for losses sustained . . . shall be the adjusted basis . . . ."[82] The taxpayer argued that this provision entitled him to a deduction equal to the difference between the car's adjusted basis and its value after the accident, which amounted to $1,635. The Commissioner argued, on the other hand, that the taxpayer was entitled to deduct a mere $35, the difference between the value of the car before and after the accident.

The United States Court of Appeals for the Second Circuit held for the taxpayer on the ground that the statute, by tying the amount of the deduction to the adjusted basis of the property, required that result.[83] The court stated that to reach any other result "we should

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77. In order to solve some of the problems in applying the exclusion in § 1221(1), one author would deal liberally with the statutory language. *See* Bernstein, *supra* note 20, at 1096-97 (advocates disregarding the word "primarily" in the language of the exclusion).

78. 350 U.S. 46 (1955).

79. *Id.* at 51.

80. *Id.* at 52. One commentator has stated that *Corn Products* "represents judicial indifference to statutory language." Bernstein, *supra* note 20, at 1116.

81. 305 U.S. 468 (1939).

82. Revenue Act of 1934, ch. 277, § 23(h), 48 Stat. 680, 689 (codified at 26 U.S.C. § 165 (1976)).

83. Helvering v. Owens, 95 F.2d 318, 319 (2d Cir. 1938), *rev'd*, 305 U.S. 468 (1939).

have to disregard the words, and should not be interpreting them, if we refused to take them just as they read."[84] The Supreme Court reversed, holding that the proper deduction was the difference between the value of the car before and after the collision.[85]

Two aspects of the Supreme Court decision in *Helvering v. Owens* warrant discussion. First, the Court rejected what a respected appellate court unanimously thought a strict construction of the statute required—a deduction determined by the adjusted basis of the property. Second, the Court effectively bifurcated the taxpayer's "loss" on the car from its adjusted basis. Only that part of the loss attributable to the accident itself was deductible; that part attributable to a decline in value during the taxpayer's personal use[86] was not deductible.[87]

Other judicial decisions have exhibited similar flexibility in construing the Internal Revenue Code.[88] In order to obtain capital gains treatment, the Code generally requires that a taxpayer engage in a "sale or exchange" of a capital asset.[89] In *Commissioner v. Brown (Clay Brown)*,[90] the Supreme Court faced the issue of whether a sale had in fact taken place when a seller and a tax-exempt purchaser

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84. *Id.*

85. 305 U.S. at 471; *accord* Treas. Reg. § 1.165-7(b) (1960).

86. Loss on the sale of property held for personal use is not deductible. *See, e.g.*, Austin v. Commissioner, 298 F.2d 583 (2d Cir. 1962); I.R.C. § 262 (1976).

87. The Supreme Court has adopted a bifurcation rule without statutory authorization in one other area of federal income tax law. Section 165(c)(2) of the Code allows an individual taxpayer to deduct "losses incurred in any transaction entered into for profit." In Heiner v. Tindle, 276 U.S. 582 (1928), a taxpayer purchased real property, used it for a time as a personal residence, then converted it to rental use, and ultimately sold it at a loss. The Supreme Court held that the predecessor of this statutory provision permitted the taxpayer to deduct the loss even though the original transaction, an acquisition for personal use, was not a "transaction entered into for profit." *Id.* at 585. The Court did not, however, allow the taxpayer to deduct the full amount of his loss, but only the difference between the fair market value of the property at the time of conversion and the amount realized upon sale. *Id.* at 587. Thus, the Court effectively bifurcated the taxpayer's loss into two elements, the loss during personal use and the loss during business use, allowing a deduction for the latter, but not the former. The Court dismissed the government's argument that such a rule would involve administrative difficulties. *Id.* at 586; *accord* Treas. Reg. § 1.165-9(b) (1960).

88. The Supreme Court has, for example, superseded the ostensibly unambiguous words of the statute by endorsing a sham transaction doctrine, Knetsch v. United States, 364 U.S. 361 (1960), and a business purpose requirement, Gregory v. Helvering, 293 U.S. 465 (1935), in order to combat tax avoidance abuses made possible by a literal interpretation of the language.

89. I.R.C. § 1222(3) (1976 & Supp. IV 1980) ("The term 'long-term capital gain' means gain from the sale or exchange of a capital asset . . . ."). Some provisions of the statute waive the "sale or exchange" requirement under certain circumstances. *See, e.g.*, I.R.C. §§ 331(a), 1231(a) (1976 & Supp. IV 1980).

90. 380 U.S. 563 (1964).

engaged in a sale and leaseback transaction. Because the purchase price was no more than a nonexempt purchaser would have paid for the assets, the Court held that a sale had occurred and that the profits on the transaction were taxable as a capital gain.

A subsequent case[91] involved a tax-exempt purchaser which agreed to pay, in a sale and leaseback transaction, double the amount that a nonexempt purchaser would have paid under comparable conditions. The Tax Court, distinguishing *Clay Brown* on the ground that the purchase price exceeded the fair market value of the property, held that the entire profit of the sale was taxable as ordinary income.[92] The Second Circuit reversed in part and affirmed in part, holding that the *Clay Brown* decision was inapplicable only to the extent that the proceeds of the transaction exceeded the price that a nonexempt purchaser would pay for the property in an arm's-length transaction.[93] Although the operative statutory language does not even hint at dual treatment of gain upon sale,[94] the court bifurcated the seller's gain: The part attributable to the sale of a capital asset was taxed as a capital gain, and the part attributable, in a sense, to the buyer's tax-exempt status as ordinary income.[95]

The foregoing analysis has established that dual treatment under section 1221(1) of the Code is supported both by judicial precedents and by accepted theories of statutory interpretation. A less traditional defense of a judicial rule of bifurcation, based on economic efficiency, follows.

C. *Economic Analysis*

This section establishes that: (1) An all-or-nothing, multifactor balancing test of the sort employed by courts under section 1221(1) is extremely costly; (2) deferring to Congress for a solution to this problem may be inefficient; and (3) a dual treatment rule, in addition to being fairer, is relatively efficient compared to the current test.

1. Inefficiencies of the Current Judicial Approach

a. *Avoidance Techniques*

A taxpayer who wants to subdivide or develop property to facilitate its sale or to increase his profits upon sale runs the risk under the all-

91. Berenson v. Commissioner, 59 T.C. 412 (1972), *modified*, 507 F.2d 262 (2d Cir. 1974).

92. *Id.* at 423-24.

93. Berenson v. Commissioner, 507 F.2d 262, 263 (2d Cir. 1974).

94. See *supra* note 89.

95. 507 F.2d at 268-69. The dual treatment approach of *Berenson* was followed in a subsequent Second Circuit decision. Kraut v. Commissioner, 527 F.2d 1014 (2d Cir. 1975), *cert. denied*, 425 U.S. 973 (1976).

or-nothing rule that these activities will result in a considerably higher tax on his gain. He can try to avoid the increase in tax by conveying the property for its fair market value to a separate but controlled entity that will subdivide and develop the property. The taxpayer hopes by these transactions to obtain capital gains treatment on the sale to the controlled entity while the profits realized by the entity will be taxed as ordinary income.[96]

These transactions generate considerable costs. In order to form the entity, the taxpayer must incur legal fees for advice and for drafting the requisite documents. Managing the new entity involves additional costs, however small. Moreover, the entity may be attacked as a sham by the Internal Revenue Service, which would then seek to disregard the entity for tax purposes and to attribute its activities to the taxpayer, thereby denying capital gains treatment for all of the taxpayer's profits.[97] Alternatively, the government may argue that the transfer to the controlled corporation was not a sale, but rather a capital contribution, and may seek to tax the corporation on the entire gain over the taxpayer's adjusted basis as ordinary income.[98] The taxpayer (or his corporation) will incur significant costs in resisting such an attack as will the government in prosecuting it.

The taxpayer has a less risky alternative to ensure capital gains treatment. He can convey the property for its fair market value to a genuinely independent third party who will subdivide and develop the property for sale to customers. By inducing the taxpayer to take this route to ensure capital gains treatment of the appreciation, current law generates the additional transaction costs of arranging and consummating a sale to an independent developer. In addition, a costly economic misallocation may result if the tax "penalty" on subdi-

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96. For more subtle tax avoidance techniques in this area, see Weinstein & Corbett, *Capital Gains from Real Estate after* Suburban Realty Co. v. United States, 55 Fla. B.J. 333 (1981).

97. The Tax Court has held for the government in three cases in which the facts were especially unfavorable to the taxpayer. Boyer v. Commissioner, 58 T.C. 316 (1972) (sale to a controlled corporation at an inflated price); Engasser v. Commissioner, 28 T.C. 1173 (1957) (taxpayers were real estate dealers); Kaltreider v. Commissioner, 28 T.C. 121 (1957) (taxpayers were real estate dealers and had personally incurred expenses in subdividing the property), *aff'd*, 255 F.2d 833 (3d Cir. 1958). The *Boyer* opinion suggests, however, that a taxpayer may succeed in divorcing the corporation's activities from his by selling at a price that would permit the corporation to make a profit on the venture. 58 T.C. at 326.

98. *See, e.g.*, Bradshaw v. United States, 683 F.2d 365 (Ct. Cl. 1982). If the transfer is construed as a capital contribution, the corporation's basis in the property would be determined by reference to the taxpayer's basis. I.R.C. § 362(a) (1976). Since the corporation is engaged in extensive development and sales activities, all of its gain, including the gain attributable to the pre-transfer appreciation in the value of the land, would be taxed as ordinary income.

viding and developing in the form of a higher tax on the prior appreciation[99] causes the taxpayer not to pursue these activities himself. Normally, the taxpayer will subdivide, develop and sell the property if his net after-tax income from these activities exceeds his net after-tax income from any other activity. But by making subdividing and developing less profitable, the tax "penalty" may induce the taxpayer to forego that activity which, but for the tax law, is the most efficient use of his time.[100]

b. *Cost of Negotiations*

A multifactor test results in expensive negotiations between the taxpayer and the government when the two disagree about the proper classification of subdivided realty sold by the taxpayer. By making relevant many disparate issues without any sure guidance on which is dispositive, the test requires both parties to gather and produce evidence with respect to a multitude of facts.[101] Such information-gathering and production is costly. For the same reasons, a multifactor test makes it harder for the parties to predict the outcome of litigation.[102] An inability to forecast the probable result of litigation in turn impedes the negotiation of a mutually agreeable settlement. The negoti-

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99. More precisely, the "penalty" is the difference between an ordinary income tax on the prior appreciation in value and a tax at capital gain rates on that appreciation.

100. Assume that the taxpayer could make, net of taxes, $100,000 from subdividing and developing and at most $75,000 from any other activity. Under these facts, he would normally develop the property because, in economic terms, his profit from developing exceeds his opportunity cost of developing. But if the tax "penalty" resulting from developing is $50,000, he will sell to a third party and pursue the other, less productive activity because the tax penalty reduces his profit from developing to $50,000, which is less than his opportunity cost of developing.

There may be cases in which a landowner will sell to a third party even though the maximum income he could earn from any other activity is *less* than his profit from developing. Assume, for example, that the taxpayer could net, after payment of the tax penalty, $100,000 from developing and that the most he could earn in any other activity is $75,000. Given these facts, the taxpayer would normally choose to develop. If, however, a more efficient third party could earn $200,000 from developing the land and for that reason were willing to pay the taxpayer $50,000 over the fair market value of the land, the taxpayer would be better off selling the land: His total profits would be $125,000 ($75,000 from the other activity and $50,000 extra on the sale) which exceeds what he could make by subdividing and developing the land himself. In effect, the third party's offer has increased the taxpayer's opportunity cost of developing from $75,000 to $125,000.

101. See *supra* notes 26-30 and accompanying text.

102. Empirical evidence strongly indicates that under the currently established multifactor tests the outcome of litigation is unpredictable. See *supra* notes 31-32, 36 and accompanying text.

ating process is consequently prolonged and the costs of negotiating increased.[103]

These arguments about the transaction costs generated by a multifactor test may seem to prove too much, for they suggest that all tests that weigh a multitude of different factors ought to be discarded because they are likely to increase the costs of negotiations. A decision to discard a multifactor test depends, however, on the availability of a less costly alternative rule that is perceived to be reasonably fair.[104] Some areas of tax law preclude the adoption of a simple rule to serve as a talisman in every case. Whether an activity is "engaged in for profit,"[105] for example, is a question that usually cannot be answered by focusing on one or two facts.[106] Were a court, or Congress, to adopt a litmus test in this area providing that an activity was not engaged in for profit if the taxpayer showed no profit for three consecutive years, the perceived sense of unfairness that might result from unswerving adherence to such a rule would probably more than outweigh the cost savings that the rule would undoubtedly produce.[107] Similarly, if a court were to deny capital gains treatment to any taxpayer who sold more than two parcels of real estate during any year, the sense of injustice generated by such a rule would probably negate any benefits in reduced negotiation costs. Bifurcation in cases involving a taxpayer change of purpose is, by contrast, both a less costly[108] and fairer alternative to the current multifactor test.

c. *Likelihood of Settlement*

By making the outcome of potential litigation less predictable,[109] the current multifactor test not only generates extra costs in negotia-

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103. *See* Ehrlich & Posner, *An Economic Analysis of Legal Rulemaking*, 3 J. Legal Stud. 257, 265 (1974).

104. For a discussion on balancing fairness arguments of a taxpayer against administrative costs arguments of the government, see Yorio, *The Revocability of Federal Tax Elections*, 44 Fordham L. Rev. 463, 486-88 (1975). One commentator would weigh the fairness arguments of the taxpayer more heavily than the administrative costs arguments of the government in certain cases. Popkin, *Deduction of Traveling Expenses by the Two-Worker Family—An Inquiry into the Role of the Courts in Interpreting the Federal Tax Law*, 55 Tex. L. Rev. 645, 660-62 (1977).

105. I.R.C. § 183 (1976) (limitation on deductions for expenses attributable to an activity "not engaged in for profit").

106. Treas. § 1.183-2(b) (1972) (nine factors listed as relevant to a determination of whether an activity is "engaged in for profit").

107. The Code provides for a presumption in the taxpayer's favor if he has shown a profit in two or more of the previous five consecutive taxable years. I.R.C. § 183(d) (1976).

108. See *infra* notes 135-49 and accompanying text.

109. See *supra* note 102 and accompanying text.

tions, but also reduces the chance that a dispute will be settled.[110] The all-or-nothing approach to capital gains treatment also reduces the likelihood of settlement by raising the stakes in controversy: The higher the stakes of a legal dispute, the more reason the parties have to litigate rather than settle because the costs of litigation are proportionately less compared with the amount in dispute.[111] In addition, when the stakes of a legal controversy are higher, it may be psychologically more difficult[112] for the parties to move toward an appropriate middle ground of settlement.[113] Since settlement is generally less costly than

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110. This point may be demonstrated by a simplified example. Suppose the amount in dispute between the government and Connor in the hypothetical presented in section (A) of this Part is $10,000 in additional taxes. If the parties know that the government wins in 95 of 100 litigated cases, they should settle for approximately $9,500 assuming both are risk neutral. By agreeing to settle for $9,500, the parties would approximate the average result of litigation and would save the transaction costs of litigating. Similarly, if the taxpayer is likely to win in 70 of 100 cases, the parties would settle at a figure approximating $3,000. Not being able to estimate the probability of a government or taxpayer victory makes it more difficult to reach a settlement figure.

Since the parties may have different subjective probabilities about the outcome of a case and different attitudes toward risk, the preceding scenario is somewhat unreal. Nevertheless, generally the more information the parties have about the outcome of litigation, the less dispersed their subjective probabilities of winning will be from the true probability and the more likely they will settle. *See* Posner, *An Economic Approach to Legal Procedure and Judicial Administration,* 2 J. Legal Stud. 399, 422-26 (1973).

111. R.A. Posner, *supra* note 1, at 434-36; Priest, *The Common Law Process and the Selection of Efficient Rules,* 6 J. Legal Stud. 65, 66-67 (1977). This argument depends on the apparently fair assumption that the costs of litigation do not increase proportionately with the stakes in controversy.

112. This argument is based on an intuitive notion that the greater the stakes, the more difficult it will be for the parties to move from their initial offers to a middle ground of settlement. When the stakes are less and both sides have less to lose by compromising—or win by litigating—it may be psychologically easier for the parties to compromise. If, for example, the government claims that the taxpayer owes $100,000 on the grounds that the entire profits on sales or real estate are taxable as ordinary income and the taxpayer claims he owes only a tax at capital gains rate of $40,000, it may be difficult to move to a settlement figure of $70,000 even if the probability of either side winning is 50%. If, by contrast, the amount in dispute under a bifurcation rule is only $20,000 instead of $60,000, both parties may move more readily to a compromise figure of $10,000. The frequency of litigation on this issue offers some empirical evidence that this intuition is correct. See *infra* note 114. An American Law Institute study similarly attributes the frequency of litigation in this area in part to the all-or-nothing determination that a court must now make. ALI Draft, *supra* note 23, at 332-33.

113. For another argument that an increase in the stakes of a dispute increases the likelihood of litigation, see Posner, *supra* note 110, at 419. Professor Posner demonstrates that any increase in the stakes makes the plaintiff's minimum settlement offer—the least amount he will take in settlement of his claim—grow faster than the defendant's maximum offer. Since settlement is usually contingent on the plaintiff's minimum offer being less than the defendant's maximum offer, an increase in the

litigation, reducing the likelihood of settlement means that the overall transaction costs of dispute resolution in this area will be greater.[114]

d. *Costs of Litigation*

A multifactor test increases the costs of litigation itself[115] because it requires the parties to produce evidence in court on each of the factors incorporated in the test. Admitting and evaluating a large volume of evidence consumes judicial time and increases the costs of trial.[116] The relevance of many disparate facts also makes summary judgment—an obviously efficient method of legal dispute resolution—unlikely, since

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stakes, by making the plaintiff's minimum offer grow faster than the defendant's maximum offer, is likely to reduce the chance that the parties will settle. *Id.* at 417-19.

114. Ehrlich & Posner, *supra* note 103, at 265. Empirical confirmation that the multifactor test engenders a great amount of litigation is found in a leading tax treatise, which states: "These words [property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business] have given rise to as much litigation as any others in the entire Code." 3B J. Mertens, Law of Federal Income Taxation § 22.15, at 113 (1980). Judges have also commented, sometimes quite vividly, on the frequency of litigation under § 1221(1). Biedenharn Realty Co. v. United States, 526 F.2d 409, 414 (5th Cir.) ("The problem we struggle with here is not novel. We have become accustomed to the frequency with which taxpayers litigate this troublesome question."), *cert. denied*, 429 U.S. 819 (1976); Gault v. Commissioner, 332 F.2d 94, 95 (2d Cir. 1964) ("Because there is a good deal of overlapping between business and investment property in this area, the cases are legion."); Thompson v. Commissioner, 322 F.2d 122, 123 (5th Cir. 1963) ("[The real estate-capital gains issue is] old, familiar, recurring, vexing and ofttimes elusive . . . ."); Kelley v. Commissioner, 281 F.2d 527, 528 (9th Cir. 1960) ("[T]he case law has grown to a jungle-like abundance accompanied by much of the welter and impenetrability which such fertility produces.").

115. Somewhat paradoxically, a decrease in the costs of litigation may in some cases increase overall transaction costs by making litigation more attractive than it was. *See* Posner, *supra* note 110, at 418. Parties may litigate rather than settle and this may increase overall transaction costs if litigation is still more costly than settlement.

116. A multifactor test increases the costs of appellate litigation for many of the same reasons. If, however, the appellate court views the question of whether the taxpayer held the property primarily for sale to customers in the course of a business as one of fact, as most courts do, *see, e.g.*, United States v. Burket, 402 F.2d 426, 429 (5th Cir. 1968); Eline Realty Co. v. Commissioner, 35 T.C. 1, 5 (1960); *contra* United States v. Winthrop, 417 F.2d 905, 910 (5th Cir. 1969) (multifactor test "has factual underpinnings [but the] ultimate issue is inherently a question of law"), the overall costs of appellate litigation are lower than they would be if the question were one of law. Fewer appeals will be taken by losing parties because the appellate court is unlikely to overturn a trial court's determination of fact. Also, the costs of any appeal that is taken may be somewhat less because the appellate court need only determine if the trial court's finding is " 'clearly erroneous.' " Commissioner v. Duberstein, 363 U.S. 278, 291 (1960); (quoting Fed. R. Civ. P. 52(a)). See *infra* text accompanying note 243. Even so, the appellate court must review, however cursorily, all the facts to make its determination.

a genuine issue as to any material fact precludes the trial court from granting summary judgment.[117]

A multifactor test increases the costs of the legal system in another more subtle way. Since the outcome of each case turns on a balancing test involving a number of different facts, the precedential value of any decision is lessened.[118] As a result, the legal system is missing an opportunity to accumulate a capital stock of knowledge that can be used to resolve subsequent cases. Although no two cases are exactly the same, cases can be sufficiently similar that the legal system should avoid the costs of a painstaking analysis of the facts of each. A multifactor balancing test makes duplication of these costs almost inevitable.

2. The Inefficiency of Deferring to Congress

Conceding that a multifactor test is very costly, one might nevertheless argue that it is more efficient for Congress than the courts to enact an alternative formula such as bifurcation. Two strong arguments support this position. First, given the plethora of courts deciding cases involving the federal income tax,[119] judicial change requires time to take hold. For at least part of the legal system to operate under an unfair and inefficient rule for an extended period of time is costly. Second, judicial change of an income tax rule usually requires a multiplication of litigation costs and judicial time, again because of the large number of federal courts involved.

Although congressional revision of federal income tax rules avoids these costs because it is speedy and uniform, it has its own costs which are probably higher than the costs of judicial change. It would be prohibitively expensive, perhaps impossible, for Congress to decide every issue involving federal income taxation.[120] Deciding which issues to refer to Congress for resolution is itself costly. Empirical evidence of this point is found in the rise of administrative agencies, like the Internal Revenue Service, a development that suggests that statutory rulemaking has become excessively costly in many areas.[121] Even assuming that Congress had the time to consider and resolve issues like the proper scope of the capital asset definition in section 1221, legisla-

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117. United States v. Burket, 402 F.2d 426, 430 (5th Cir. 1968).

118. *See* Ehrlich & Posner, *supra* note 103, at 266-67; Posner, *supra* note 110, at 448-51.

119. Federal income tax litigation takes place in the Tax Court, the Court of Claims and every United States District Court.

120. See *supra* notes 63-67 and accompanying text. *See* Ehrlich & Posner, *supra* note 103, at 280 ("We must also consider . . . the increase over time in the cost of statutory rulemaking brought about by the fact . . . that legislatures cannot be expanded to handle a rising workload without very sharp increases in the costs of enactment.").

121. Ehrlich & Posner, *supra* note 103, at 280.

tive revision itself involves significant costs. The transaction costs of obtaining the approval of the requisite number of congressmen are high, even if the approval of just the members of the tax writing committees is, as a practical matter, sufficient.[122] Moreover, Congress rarely focuses on a single issue in federal tax law; usually a proposal to change a particular provision of the Code becomes part of a larger income tax package involving complex political, economic and social issues. Once that more inclusive process begins, it may be difficult to reach a proper resolution of each of the relatively minor provisions included in the bill.

Furthermore, the transaction costs of a change in the judicial view of the section 1221(1) exclusion are probably not as high as in other areas of tax law. Since courts frequently address the issue of the capital asset definition,[123] judicial change can come reasonably quickly and uniformly. In addition, since bifurcation is the fairest and most accurate result under section 1221(1),[124] the acceptance of a rule of bifurcation by one court may soon induce other courts to follow suit. There is, finally, no guarantee that Congress will ever act on an income tax issue of this sort. By deferring to Congress courts run the risk that the income tax system will continue to operate under a rule that is both inefficient and unfair. The costs of such deference may be high.[125]

3. The Relative Efficiency of Bifurcation

Those scholars who advocate dual treatment in change of purpose cases are concerned about the administrative difficulties that bifurcation might entail.[126] Since the courts now employ a test that is itself extremely costly,[127] there is little to fear from adopting a different rule, at least from the standpoint of administrative efficiency.

a. *Mechanics of Bifurcation*

In order to implement a rule that provides for dual treatment of gain or loss on the sale of an asset that the taxpayer held first as an

122. *See id.* at 267.
123. See *supra* note 114.
124. See *supra* notes 22-24 and accompanying text.
125. In his dissenting opinion in Martin v. Commissioner, 649 F.2d 1133 (5th Cir. 1981), Judge Goldberg noted:

> While the certainty of an erroneous solution may represent a temporary comfort for those who embrace it, it may well represent an injustice for those who are subject to it. When charged with a duty to correct a remediable and harmful error in the law, judicial restraint can only represent judicial abdication.

Id. at 1144. (Goldberg, J., dissenting).
126. See *supra* note 38 and accompanying text.
127. See *supra* text accompanying notes 96-118.

investment and then for sale to customers in a business, two crucial questions must be addressed: First, when did the taxpayer's activities with respect to the property change from investment to sale in a business; and second, what was the value of the property at the time of conversion? Although answering either question may be difficult in a particular case, a 1960 draft study published by the American Law Institute (ALI) advocating a statutory rule of bifurcation provides guidance on isolating the factors that should be determinative in identifying a change in purpose from investment to sale to customers in a business.[128] The draft study recommends that, except in the case of a taxpayer who is a dealer or a trader,[129] the time of conversion[130]

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128. *See* ALI Draft, *supra* note 23, at 26-27, 33-35, 94-96, 339-42.

129. Under the ALI draft study, a taxpayer is a dealer with respect to assets "if he holds himself out as ready to buy and sell those assets or if he otherwise performs the functions of a merchant or middleman with respect to those assets." *Id.* § X1221(e)(2)(A), at 26. A taxpayer is a trader with respect to assets "if he acquires those assets for the purpose of resale and engages in a significant number of either purchases or sales of those assets." *Id.* § X1221(e)(2)(B), at 26.

130. According to the ALI draft study, if a taxpayer has *always* been a dealer or a trader with respect to the property in question, his gain or loss upon sale should be entirely ordinary income or loss. *Id.* §§ X1221(e)(2)(A)-(B), at 26, X1237(a), at 33-34. Although a *dealer* should get ordinary income treatment, a *trader*, contrary to the draft study's recommendation, should not receive ordinary income treatment on his entire gain or loss on the sale of an asset. The draft study's recommendation perpetuates the unjustified difference in treatment under current law between traders in securities, who receive capital asset treatment on sales of securities, and traders in other assets, who may receive ordinary income treatment. *See* Van Suetendael v. Commissioner, 152 F.2d 654 (2d Cir. 1945). *Compare* ALI Draft, *supra* note 23, § X1221(e)(1)(A), at 25-26 *with id.* § X1221(e)(2)(A)-(B), at 26. So long as the taxpayer is not a dealer with respect to the assets, there is no reason to deny the taxpayer dual treatment of the gain or loss upon a sale of his assets.

Occasionally a taxpayer will purchase an asset at a time when he is not a dealer or a trader and will *later* become a dealer or a trader with respect to this type of asset. The ALI draft study recommends that the time of conversion in such a case be fixed at the earlier of: (1) the point in time when the taxpayer became a dealer or trader; (2) the point in time when he made a significant number of sales; or (3) the point in time when he engaged in substantial development activities. *Id.* §§ X1221(e)(2), at 26-27, X1237(a), at 33-34. In addition to denying the relevance of the taxpayer's status as a trader, a separate determination of when the taxpayer became a dealer is unnecessary because that point in time will rarely precede the time when he makes a significant number of sales of property. See *supra* note 129 (definition of a dealer). The ALI draft study also allows a dealer to receive capital asset treatment on the sale of a particular asset if he can establish "by clear proof" that the asset is "not held by him primarily for sale to customers in the ordinary course of his trade or business." ALI Draft, *supra* note 23, § X1221(e)(3), at 27. Current case law similarly allows a dealer to obtain capital asset treatment on the sale of particular property if he can establish that the property was set aside as an investment. *See, e.g.*, United States v. Bondurant, 245 F.2d 265 (6th Cir. 1957) (cotton); Eline Realty Co. v. Commissioner, 35 T.C. 1 (1960) (real estate). The Code specifically allows a *securities* dealer to get capital asset treatment on a security clearly identified within 30 days of its acquisition as a security held for investment. I.R.C. § 1236(a) (1976).

be fixed at the earlier of (1) the point in time at which the taxpayer made a significant number of sales of the property; or (2) the point in time at which the taxpayer engaged in substantial development activities preparatory to sale.[131] Once the time of conversion from investment to business is determined, the value of the property at that time[132] would serve as the basis for bifurcating the taxpayer's gain or loss upon sale into capital and ordinary elements: That part of the gain or loss upon sale measured by the difference between the value of the property at the time of conversion and the basis of the property is, at the risk of oversimplification, capital;[133] any subsequent gain or loss is ordinary.

Since frequent sales and substantial development activities are indeed the factors that reveal most clearly a change in purpose from investment to sale to customers in a business, the ALI formula should form the basis of a judicial rule of bifurcation. To be sure, either the taxpayer or the government may argue that restricting analysis to these two factors is inappropriate under the circumstance of a particular case. Although this argument may have some merit, a line must be drawn somewhere. One of the advantages of a dual treatment rule is that less depends on where the line of conversion is drawn because some of the gain or loss will usually be capital, some ordinary. By contrast, under the current all-or-nothing approach, so much more depends on the outcome of the multifactor test that courts are rightly reluctant to focus on just one or two factual issues.[134] A dual treatment rule, by reducing the amount of tax liability that hinges on the out-

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131. *See* ALI Draft, *supra* note 23, §§ X1221(e)(2)(C), at 26-27, X1237(a), at 33-34. The ALI proposal would apply a dual treatment rule only if the taxpayer held the property as a capital asset for five years prior to the time of conversion from investment to business. *Id.* § X1237(a)(2), at 34. The proposal also allows a taxpayer to "sanitize" development activities if he waits five years after such activities before he sells. *Id.* § X1221(e)(2)(C), at 27.

132. More precisely, the ALI study sets the valuation date at "the first day of the taxable year" in which the conversion occurred. *Id.* § X1237(b), at 34-35. The reason for setting the valuation date in this way is to avoid the problem of having to determine the exact date on which the conversion occurred. *Id.* at 339.

133. This statement is accurate when the value of the property continues to move in the same direction after the conversion as it did before. Assume, for example, that basis is 100, value upon conversion is 200, amount realized is 300. Of the gain of 200 upon sale, 100 is capital gain and 100 is ordinary income. Similarly if the basis is 300, the value at the time of conversion is 275, and the amount realized is 250, 25 of the 50 loss upon sale is a capital loss and 25 is an ordinary loss. Complications arise, however, when the value of the property moves in the opposite direction after conversion. Assume, for example, that the basis is 100, the value upon conversion is 75, and the amount realized is 120. Given these facts, the taxpayer's gain upon sale of 20 probably should be treated as ordinary income since it arose after the time of conversion. For a fuller discussion of these problems, most of which are easily solved, see *id.* at 34-35, 94-95, 337 n.18.

134. See *supra* text accompanying notes 104-08.

come of the test, makes it more legitimate for a court to limit its inquiry to a few key factual issues.

b. *The Advantages of Bifurcation*

A dual treatment rule similar to the proposal outlined above avoids considerable costs generated by the current all-or-nothing, multifactor approach. Not the least important cost saving is that bifurcation eliminates the incentive to devise costly and inefficient techniques for avoiding the tax penalty which is now effectively levied upon the taxpayer who subdivides or develops property to facilitate its sale.[135] Under a rule providing for dual treatment of gain, a taxpayer may sell as many lots as will produce maximum profits and may develop as is necessary to expedite sale, secure in the knowledge that these activities will not taint the gain that accrued during the prior investment period.

By focusing on three key factual issues[136]—frequency of sales, substantial development activities, and the value of the property at the time of the earlier of the two—a dual treatment rule reduces the number of factual issues that are legally relevant on audit, in settlement negotiations and in litigation between the taxpayer and the government.[137] The parties and the courts no longer need to evaluate disparate factual issues such as what proportion of the taxpayer's total income was derived from sales of property, whether the taxpayer employed a broker or used a business office in conducting sales, whether the taxpayer advertised or engaged in other sales promotional activities, and how much of the taxpayer's time was spent in sales activities. The consequence of limiting the apposite factual issues to just three should be lower costs of settlement negotiations and litigation.[138] Bifurcation does of course add to the mix of relevant factors one issue that heretofore has not been expressly[139] significant, namely the value of the property at the time of conversion. The Code[140] and

135. See *supra* notes 96-100 and accompanying text.

136. In an occasional case the government or the taxpayer will argue that the taxpayer is a dealer and thus should not receive capital asset treatment for any part of his gain or loss. See *supra* note 130. In those relatively few cases it may be necessary to inquire into a broader range of factual issues to determine whether the taxpayer "holds himself out as ready to buy and sell" or "if he otherwise performs the functions of a merchant or middleman." See *supra* note 129.

137. See *supra* text accompanying note 28.

138. See *supra* notes 101, 115-16 and accompanying text.

139. Moreover, value at the time of conversion may be an issue under current law because courts tend to favor the taxpayer's position if a large portion of his gain accrued before frequent sales or development activities. *See* Freedman & Solomon, *supra* note 23, at 299.

140. I.R.C. § 631(a) (1976) (taxpayer may elect to report as capital gain the difference between the fair market value of cut timber—on the first day of the taxable year in which such timber is cut—and the adjusted basis for depletion of such timber). *See* ALI Draft, *supra* note 23, at 335.

the cases,[141] however, address valuation issues in similar contexts, without insurmountable difficulty. This suggests that the costs created by the addition of a potentially controversial valuation issue are not always high and would often be lower than the costs saved by the removal of at least four other issues from the battleground of negotiation and litigation in this area.

More important perhaps than the sheer reduction in the number of relevant facts is that a dual treatment rule allows the parties and judicial fact-finders to focus analysis on a few *objective* facts rather than on the *subjective* intentions of the taxpayer. The multifactor test, by contrast, attaches some importance to the taxpayer's subjective purpose with respect to the property at three different points in time: when he bought the property, during the period he held the property and when he sold the property.[142] Inquiries into a taxpayer's subjective purpose can be difficult and often costly because they not only require a review of all those objective manifestations that bear on the taxpayer's purpose, but they also call for testimony, by the taxpayer and perhaps others, about his subjective intentions.[143]

Finally, a dual treatment rule increases the chances for settlement of disputes between taxpayers and the government. Knowing that only a few facts are relevant to the judicial outcome, the parties will be better able to predict the probable outcome of litigation; the more the taxpayers know about the outcome of litigation, the more likely they are to settle.[144] By reducing the stakes in controversy, a rule of dual treatment makes litigation less likely for two other reasons: First, the parties will be less willing to incur the costs of litigation because these costs will loom proportionately larger compared to the amount in dispute;[145] second, with less at stake the parties will find it easier to move to an acceptable middle ground of settlement.[146] This increase in the probability of settlement will reduce the total costs of legal dispute resolution.[147]

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141. See *supra* notes 81-95 and accompanying text. *See* ALI Draft, *supra* note 23, at 334-35.

142. The taxpayer's purpose at the time of sale is usually more important than his purpose in acquiring or holding the property. *See* Bernstein, *supra* note 20, at 1109-11. But his purpose at those other points in time may also be important. *Id.* at 1110.

143. For a discussion of the problems caused by a rule that requires an inquiry into a taxpayer's subjective purpose, see Klein, *The Deductibility of Transportation Expenses of a Combination Business and Pleasure Trip—A Conceptual Analysis*, 18 Stan. L. Rev. 1099, 1107-12 (1966). Professor Klein recommends a movement toward an objective test as a way of eliminating these problems. *Id.* at 1112-18.

144. See *supra* note 110 and accompanying text.

145. See *supra* note 111 and accompanying text.

146. See *supra* notes 112-13 and accompanying text.

147. See *supra* note 114 and accompanying text.

In summary, a rule of dual treatment in cases involving a change of purpose by the taxpayer is almost certainly[148] more efficient than the current test: It eliminates costs associated with tax avoidance plans, probably reduces the costs of negotiation and litigation and, most importantly, increases the likelihood that the parties will settle rather than engage in costly litigation.[149]

II. Substantiation of Deductions

A. *The* Cohan *Doctrine*

In the celebrated decision of *Cohan v. Commissioner*,[150] George M. Cohan, the famous showman, had deducted a total of $55,000 in entertainment and travel expenses on three tax returns during the early 1920's. The government sought to disallow the deductions because Cohan was unable to substantiate the amount of any expense. The Board of Tax Appeals, agreeing with the government, refused to allow Cohan any deduction on the grounds that, in the absence of any items or details, it was impossible to determine how much he had in fact spent or exactly what portion represented nondeductible personal expenses.[151] The Second Circuit, in an opinion by Judge Learned Hand, reversed and ordered the Board to make as close an approximation as it could.[152] Justice Hand noted:

> But to allow nothing at all appears to us inconsistent with saying that something was spent . . . . The amount may be trivial and unsatisfactory, but there was basis for some allowance, and it was wrong to refuse any, even though it were the traveling expenses of a single trip. It is not fatal that the result will inevitably be speculative; many important decisions must be such.[153]

The decision of the Second Circuit had two principal effects: the first, retrospective, in adjusting the rights and duties of the parties; the second, prospective, in influencing the behavior of taxpayers and the government in future situations involving travel and entertainment expenses. With respect to the rights of the litigants, the Second Circuit made two arguments on Cohan's behalf. First, the court opined that the difficulties of recordkeeping for travel and entertainment expenses

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148. Without detailed and costly empirical research, certainty about the relative efficiency of the two rules is impossible, but the *a priori* evidence and the available empirical evidence strongly indicate that a dual treatment rule minimizes costs. See *supra* note 15.

149. *See* ALI Draft, *supra* note 23, at 334 ("[Dual treatment,] by facilitating the settlement of controversies, will in the end simplify the administration of the law.").

150. 39 F.2d 540 (2d Cir. 1930).

151. George M. Cohan, 11 B.T.A. 743, 761 (1928), *rev'd*, 39 F.2d 540 (2d Cir. 1930).

152. 39 F.2d at 543-44.

153. *Id.* at 544.

for a person in Cohan's position were considerable.[154] Second, the court decided that it would be unfair to deny a deduction for all of Cohan's expenses when the government conceded that some deductible expenses had in fact been incurred.[155]

Strong countervailing arguments, however, support the government's position. Although recordkeeping for some expenses might have been difficult, there is no suggestion that it was impossible.[156] The court may have been right that "[a]bsolute certainty in such matters is usually impossible,"[157] but certainty about many of the expenses was possible. To allow Cohan an approximate deduction for those easily verified expenses was overly generous to the taxpayer. Furthermore, Cohan's carelessness in making no effort to keep records of any expense undermined his entire claim. For these reasons, then, had the Second Circuit refused to extricate him from a problem substantially of his own making, the decision would have been defensible.

A more telling criticism of *Cohan* is that the court disregarded the predictable and deleterious prospective effect of its decision: Taxpayers now had an incentive not to keep adequate records of travel and entertainment expenses in the hope that a satisfactory—or more than satisfactory—approximation would be reached either in litigation or in negotiations with government auditors. As a consequence of a rule of approximation, taxpayers might even exaggerate their deductions in order to achieve a favorable settlement or judgment.[158] The prospective effect of the *Cohan* doctrine in fact proved to be disastrous.[159] As a result, Congress in 1962 amended the Code to effectively overrule the *Cohan* doctrine with respect to travel and entertainment expenses.[160] Nevertheless, courts, relying on *Cohan*, have continued to

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154. *Id.* at 543.

155. *Id.* at 543-44.

156. Judge Hand may have exaggerated the difficulty of Cohan's keeping records of his expenses. Conceivably there is a sociological, as well as a legal, explanation for the chasm that separates the 1930 *Cohan* decision from the current statutory provision, I.R.C. § 274(d) (1976), which requires detailed substantiation. Perhaps it was not so much difficult as incongruous for Cohan, a showman in the Roaring Twenties, to keep close tabs on his entertainment expenses. It would have been almost unimaginable, and certainly disillusioning, for a Babe Ruth, a Jack Dempsey or a Rudolph Valentino to ask a bartender for a receipt after ordering drinks for sports writers or film critics at a local speakeasy. Nowadays we almost expect our reigning movie stars and athletes to be accompanied by their lawyer or accountant as they entertain, and we envision the lawyer or accountant asking for a receipt on their behalf.

157. 39 F.2d at 543.

158. For a discussion by a former Commissioner of the Internal Revenue Service of the problems that the *Cohan* doctrine caused, see Caplin, *The Travel and Entertainment Expense Problem*, 39 Taxes 947, 958-64 (1961).

159. *Id.*

160. Revenue Act of 1962, Pub. L. No. 87-834, 76 Stat. 960, 975 (codified at 26 U.S.C. § 274(d) (1976)) (specific requirements for substantiating travel and enter-

apply the "best estimate" rule to approximate the amount of other deductible expenses.[161] As the next section shows, however, an approximation rule generates costs that would almost certainly be reduced by a rule requiring substantiation of expenses.[162]

B. *Economic Analysis of the* Cohan *Doctrine*

In a determination of which rule, substantiation or approximation, is preferable on efficiency grounds, the rules must be compared from the standpoint of two different types of costs: (1) the indirect costs of legal error caused by applying the rule; and (2) the direct transaction costs that the rule generates in administering the deduction.[163]

1. Costs of Legal Error

The costs of legal error are the product of two factors: the probability of error and the costs of error, if error occurs.[164] A rule of approximation generates higher costs of legal error than does a rule of substantiation. To begin with, under a rule of approximation there is a great probability of legal error because a government auditor or judge must attempt to reconstruct circumstances surrounding expenses allegedly incurred some years earlier without the aid of objective evidence such as a record of the time and place at which the expense was incurred or of the amount and purpose of the expense. Requiring

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tainment expenses). The Code also requires more generally that the taxpayer "keep such records . . . as the Secretary may from time to time prescribe." *Id.* § 6001; *see* Treas. Reg. § 1.6001-1 (1981).

161. *E.g.*, NCNB Corp. v. United States, 651 F.2d 942, 962-63 (4th Cir. 1981) (ordinary and necessary business expense); Lollis v. Commissioner, 595 F.2d 1189, 1190-91 (9th Cir. 1979) (same); Cummings v. Commissioner, 410 F.2d 675, 678-80 (5th Cir. 1969) (same); *see* 9 J. Mertens, Law of Federal Income Taxation § 50.62, at 173 n.17 (rev. ed. 1977).

That Congress has explicitly rejected the *Cohan* doctrine in the area in which it was enunciated ought to encourage courts to reject it more generally. See *supra* note 46. On the other hand, Congress's failure in 1962 to require substantiation more generally may be interpreted as acceptance of an approximation rule. This seems unpersuasive for at least two reasons. First, Congress addressed the one issue brought to its attention in 1962, namely abuses of the *Cohan* doctrine in the context of travel and entertainment expenses. Its nonaction in other areas thus should not be interpreted as acquiescence in approximation as a general rule. Second, the Code requires taxpayers to "keep such records . . . as the Secretary may from time to time prescribe." I.R.C. § 6001 (1976 & Supp. IV 1980). This requirement suggests that Congress rejects the underlying rationale of the *Cohan* decision, that a taxpayer is entitled to the benefits of the "best estimate" rule because it may be difficult to keep records.

162. In the absence of detailed empirical research, it is impossible to be absolutely certain that costs are reduced by a substantiation rule. See *supra* note 15.

163. Posner, *supra* note 110, at 400-02; Schwartz & Tullock, *The Costs of a Legal System*, 4 J. Legal Stud. 75, 79 (1975).

164. Posner, *supra* note 110, at 401.

substantiation, by contrast, would significantly reduce the chances of legal error in disputes involving deductible expenses. Furthermore, since taxpayers would be aware that the statute requires substantiation, their tax returns more likely would be accurate, thus reducing the chances of legal error even on those tax returns that are not audited. Although some taxpayers may still neglect to keep records and others may fabricate the required information at some risk,[165] a rule of substantiation provides a strong incentive to claim accurate deductions and to maintain records that will reduce the probability of legal error.

Not only is the probability of legal error greater, but the costs of error, if error occurs, are likely to be greater under an approximation rule. In addition to the usual costs incident to legal error,[166] such as a loss in revenue resulting from an excessive deduction, the federal tax system incurs a subtle, but pernicious, cost from the legal errors caused by the *Cohan* doctrine. Because some taxpayers, by exaggerating deductible expenses,[167] may profit from the legal rule that allows a favorable yet unsubstantiated approximation of their expenses, other taxpayers, who are scrupulous or who are not able to claim the particular deduction, have reason to resent a system in which some taxpayers are not paying their fair share of taxes.[168] Such resentment is particularly costly in a system like the federal income tax, which primarily relies on voluntary compliance by participants who, when they see others cheat, may be induced to cheat themselves.[169]

2. Transactions Costs

a. *Taxpayer Compliance Costs*

A rule of approximation reduces the costs of taxpayer compliance because it allows taxpayers to avoid the time and expense of keeping records by offering the prospect of a satisfactory deduction without

165. The risk is that a court will impose a negligence or a fraud penalty. I.R.C. §§ 6653, 7201, 7207 (1976).

166. For an analysis of the costs resulting from legal error in certain areas of the law, see Posner, *supra* note 110, at 402-15.

167. For a discussion of the possibility that taxpayers may exaggerate their expenses to secure a favorable approximation, see Caplin, *supra* note 158, at 961.

168. *Id.* at 963. A House subcommittee report stated: "This record-keeping proposal . . . should reduce the risk that the great multitude of taxpayers who have no substantial business deductions may feel that some persons . . . are not paying their fair share of taxes." Subcommittee on Administration of the Internal Revenue Laws, Report to House Comm. on Ways and Means 29 (1952), *quoted in* B. Bittker & L. Stone, Federal Income Taxation 315 (5th ed. 1980) [hereinafter cited as Subcomittee Report].

169. Caplin, *supra* note 158, at 947, 963.

substantiation.[170] By contrast, overall taxpayer compliance costs under a substantiation rule are considerable because they are incurred by all taxpayers who may possibly claim a deduction, not just by those taxpayers who happen to be audited.[171] Furthermore, the cost to society generally increases with the taxpayer's income because the more valuable his time, the greater the cost of substantiation caused by his foregoing other activity to comply with the statute.[172] An additional drawback of a substantiation requirement is that it may cause some taxpayers to resent a system which, in their opinion, mires them in a welter of bureaucratic details.[173] On the other hand, an approximation rule also sparks friction between taxpayers and the system because agents who do not get documentation of expenses may be induced to delve more deeply into the taxpayer's personal affairs and even to question his honesty.[174]

b. *Costs of Audit, Negotiation and Litigation*

A rule that requires substantiation of deductible expenses ensures that objective evidence will be available by which to determine the merits of the taxpayer's claim. The availability of this evidence reduces the costs of audit, negotiation, settlement and litigation.[175]

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170. A taxpayer may deduct his out-of-pocket expenses in complying with the substantiation rule. I.R.C. §§ 162, 212 (1976). The government therefore bears part of these costs to the extent of a taxpayer's marginal tax bracket. Whether borne by the government or by taxpayers, the expenses still represent a cost to society.

171. On the problems of recordkeeping for small businesses, see C. H. Gustafson, *supra* note 6, at 379-80. It is possible to eliminate some of the costs of taxpayer compliance by tolerating *de minimis* exceptions to a substantiation requirement. Indeed, the current statutory provision that mandates substantiation for travel and entertainment expenses authorizes the Secretary of the Treasury to promulgate regulations making inapplicable some or all of the substantiation requirements in appropriate situations. I.R.C. § 274(d) (1976). The Internal Revenue Service has approved a number of exceptions. Treas. Reg. § 1.274-5(c)(2)(7) (1981). Even with exceptions, however, the overall costs of taxpayer compliance are increased by a substantiation requirement.

172. Perhaps Judge Hand had this in mind when he allowed Cohan, a busy man whose time was valuable, to get a deduction without substantiation. This argument suggests that the higher a taxpayer's income, the less efficient a rule of substantiation is. Of course, there is a built-in check on the costs generated by a substantiation rule: A rational taxpayer will keep a record of an expense only if the value of deducting the expense exceeds his opportunity cost in keeping a record of it. Furthermore, the notion that high-income taxpayers have a stronger claim to an approximation rule than low-income taxpayers is not only unegalitarian, but, if implemented, would create substantial and costly morale problems among taxpayers. See *supra* notes 167-69 and accompanying text.

173. *See* Gluck, *How Cohan Works: Allowance of Business Expense Deductions When No Exact Records are Kept*, 6 Rutgers L. Rev. 375, 401 (1952).

174. *See* Caplin, *supra* note 158, at 963-64.

175. It would be possible, of course, to design an approximation rule that would substantially reduce the costs of audit, negotiation, settlement and litigation. If, for

Under the *Cohan* doctrine, by contrast, the costs of gathering this evidence and of properly investigating and preparing a case are substantial.[176] Moreover, a substantiation rule places the burden of gathering the relevant information on the taxpayer while an approximation rule places on the government the burden of reconstructing the taxpayer's expenses and of arriving at a fair approximation. As between a rule that puts the burden on the taxpayer and another that puts the burden on the government, the former is generally more efficient because it is usually less costly for a taxpayer with access to the relevant information to produce it than for the government to reconstruct it.[177]

Furthermore, a rule of substantiation, by making it more likely that a claimed expense is legitimate, enables the government to operate at lower cost by reducing the number of audits and by devoting less time on audit to deductible expenses.[178] Moreover, under a substantiation requirement, virtually all the facts as well as the fundamental legal rule are clear. Thus, in most cases the probable outcome of litigation will be predictable, which reduces the likelihood that litigation, a costly method of resolving legal disputes, will occur.[179] A rule of approximation, by contrast, invites litigation because the facts are uncertain and the judicial outcome unpredictable.[180]

Finally, a substantiation requirement eliminates the need for discretionary determination of the proper deduction by revenue agents. Vesting such discretion in government officials results in significant costs because it spawns opportunities for possible corruption in the Internal Revenue Service.[181] A heightened sense that agents may be

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example, the Code provided that a taxpayer could deduct 5% of his gross income for travel and entertainment expenses without documentation, this rule would reduce transaction costs substantially, but with considerable loss in accuracy. The *Cohan* doctrine is not, in any event, a flat, easily administered rule since it makes an approximation dependent upon factors peculiar to the taxpayer in question.

176. *See* Caplin, *supra* note 158, at 960.

177. In economic terms, the taxpayer is the cheaper cost-avoider of the costs of determining the facts pertaining to his travel and entertainment expenses. For a discussion of the cheapest cost-avoider principle, see G. Calabresi, *supra* note 1, at 135-40.

178. As a result of the *Cohan* doctrine, the most frequent issue at informal audit conferences was the travel and entertainment expense deduction. Caplin, *supra* note 158, at 959-60.

179. For a discussion of the effect of outcome predictability on the likelihood of litigation, see *supra* notes 102-03, 109-14 and accompanying text.

180. One authority commented, "[t]he *Cohan* doctrine has added litigious and abrasive elements into our tax system." Caplin, *supra* note 158, at 959.

181. In a report to the House Committee on Ways and Means, the Subcommittee on Administration of the Internal Revenue Laws recommended:

> A second way to reduce possible corrupt practices in the Bureau [of Internal Revenue] is to minimize the opportunities and temptation. For example, under a leading judicial decision [the *Cohan* case], a taxpayer

corrupt in turn adversely affects taxpayer morale[182] and increases the costs of policing government auditors and other decision-makers.[183]

III. The Meaning of "Gift"

A. *The* Duberstein *Rule*

Commissioner v. Duberstein and *Stanton v. United States*, decided simultaneously by the Supreme Court,[184] raise the common problem of assigning meaning to the term "gifts," which under section 102(a) of the Code are excluded from a taxpayer's gross income.[185] Duberstein was the president of an iron and metal company that did business with another metal company, of which one Berman was president. From time to time Duberstein would inform Berman of potential customers in whom Duberstein's own company was not interested. One day in 1951 Berman telephoned Duberstein to tell him that this information proved so helpful that he wished to give Duberstein a present. Although Duberstein stated that Berman owed him nothing, Berman insisted that he accept a Cadillac as a gift. Duberstein finally did so even though he had two other cars, one of which was a Cadillac.

Duberstein did not include the value of the Cadillac in his gross income for 1951, deeming it a gift. The Commissioner asserted a deficiency. At trial, Duberstein testified that he did not think Berman

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> who claims large business deductions but has not kept any records to substantiate the claim is entitled to a reasonable allowance for the claimed expenses . . . . Stricter requirements for keeping of reasonably detailed records by taxpayers would eliminate the necessity for discretionary determination of the proper expense deduction, and with it, any possible temptation for the Revenue Agent to allow an improperly large deduction in exchange for some private benefit extended to him by the taxpayer.

Subcommittee Report, *supra* note 168, at 29.

182. *Id.*

183. Ehrlich & Posner, *supra* note 103, at 267. The elder Seligman makes a similar point about a presumptive income tax: "Unless the presumptions are exceedingly simple, the discretion afforded to the officials is liable to abuse." E.R.A. Seligman, The Income Tax: A Study of the History, Theory and Practice of Income Taxation at Home and Abroad 659 (2d ed. 1914).

184. 363 U.S. 278 (1960).

185. The full text of § 102(a) of the Code reads: "General rule.—Gross income does not include the value of property acquired by gift, bequest, devise, or inheritance." The problem of determining when a transfer in a commercial context is an excludable gift has been alleviated somewhat by the enactment of § 274(b) of the Code. I.R.C. § 274(b) (1976). Under this provision, a transferor generally may deduct only $25 of the amount of a business gift. As a consequence of this provision the transferor and transferee generally have conflicting interests regarding the classification of the transfer under § 102, with the latter arguing that the transfer is a gift and the former arguing that it is not a gift. Since transferors will be less inclined because of § 274(b) to make transfers that may be treated as gifts under § 102, the problem of determining when a transfer is a gift will arise less often.

would have given him the Cadillac if he had not furnished him with information about customers. The Tax Court sustained the Commissioner's determination on the grounds that the record was barren of evidence revealing an intention on the part of Berman to make a gift.[186] The United States of Court of Appeals for the Sixth Circuit reversed.[187]

Stanton had been an employee of Trinity Church in New York City for ten years, serving as comptroller of the Church corporation and president of its wholly owned subsidiary, Trinity Operating Company. After some reported ill-feeling between Stanton and the directors of the Operating Company over the termination of the services of another employee, Stanton tendered his resignation, which was at first rejected, but then accepted. Three weeks later, the directors of the Operating Company resolved to award Stanton a "gratuity" of $20,000, payable in 10 monthly installments, provided that Stanton release the Operating Company from all pension and retirement benefits not already accrued. Stanton in fact had no right to unaccrued benefits. After his resignation, he was not required to perform further services for Trinity or its Operating Company. The trial judge, sitting without a jury, made the simple finding that the payments were a gift and judgment was entered for the taxpayer.[188] The United States Court of Appeals for the Second Circuit reversed.[189]

The opinion of the Supreme Court in the consolidated decision, *Commissioner v. Duberstein*,[190] merits close scrutiny. The Court began its analysis by noting the "meaning of the term 'gift' as applied to particular transfers has always been a matter of contention" and "[s]pecific and illuminating legislative history on the point does not appear to exist."[191] The government had proposed that gifts be defined as "transfers of property made for personal as distinguished from business reasons."[192] The Court rejected this test, however, on the grounds that "the governing principles [in this area] are necessarily general" and "that the problem is one which . . . does not lend itself to any more definitive statement" that could serve as a talisman to resolve concrete cases.[193] The Court instead reaffirmed the following broad principles enunciated in earlier Supreme Court opinions: The

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186. Duberstein v. Commissioner, 17 Tax Ct. Mem. Dec. (CCH) 16 (1958), *rev'd*, 265 F.2d 28 (6th Cir. 1959), *rev'd*, 363 U.S. 278 (1960).

187. Duberstein v. Commissioner, 265 F.2d 28 (6th Cir. 1959), *rev'd*, 363 U.S. 278 (1960).

188. Stanton v. United States, 268 F.2d 727, 728 (2d Cir. 1959), *vacated sub nom.* Commissioner v. Duberstein, 363 U.S. 278 (1960).

189. *Id.* at 729.

190. 363 U.S. 278 (1960).

191. *Id.* at 284.

192. *Id.* at 284 n.6.

193. *Id.* at 284-85.

word "gift" in the statute is used in a colloquial, everyday sense and not in the common-law sense;[194] a gift does not proceed from "'the constraining force of any moral or legal duty'";[195] a gift arises out of "'detached and disinterested generosity'"[196] and out of "'affection, respect, admiration, charity or like impulses.'"[197] The critical fact, according to the Court, is the dominant reason that explains the transferor's action in making the transfer.[198] In further criticism of the government's test, the Court noted that the standard depended on a set of presumptions[199] derived from previous cases which, the Court stated, are "not principles of law but rather maxims of experience" subject to exceptions and qualifications.[200] Some of these presumptions would be difficult for a trial court to apply either because the presumption depends on the local law of corporations or because the presumption hinges on the resolution of a distinct and often complex issue under federal income tax law.[201]

The Court, in short, rejected all tests and presumptions and instead viewed the assigning of meaning to the word "gift" as a determination to be made by the fact-finding tribunal:

> Decision of the issue presented in these cases must be based ultimately on the application of the fact-finding tribunal's 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.[202]

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194. *Id.* at 285.

195. *Id.* (quoting Bogardus v. Commissioner, 302 U.S. 34, 41 (1937)).

196. 363 U.S. at 285 (quoting Commissioner v. LoBue, 351 U.S. 243, 246 (1956)).

197. 363 U.S. at 285 (quoting Robertson v. United States, 343 U.S. 711, 714 (1952)).

198. 363 U.S. at 286.

199. The government test was derived from such presumptions as the following: "that payments by an employer to an employee, even though voluntary, ought, by and large, to be taxable; that the concept of a gift is inconsistent with a payment's being a deductible business expense; that a gift involves 'personal' elements; that a business corporation cannot properly make a gift of its assets." *Id.* at 287.

200. *Id.*

201. *Id.* at 288-89. For example, to test the validity of the presumption that a business corporation cannot properly make a gift of assets, the trial court would have to determine whether the corporation could validly make a gift under the applicable state corporation law. To apply the presumption that the concept of a gift is inconsistent with a payment's being a deductible business expense, the trial court would have to determine whether the transfer was deductible as a business expense, an issue that, as the Court noted, is frequently fraught with complication and difficulty.

202. *Id.* at 289.

Although the Court conceded that this conclusion does not "satisfy an academic desire for tidiness, symmetry and precision," it stated that if "uncertainty or overmuch litigation" is a problem, "Congress may make more precise its treatment of the matter by singling out certain factors and making them determinative . . . ."[203] Until then, the question remains essentially a factual one, the scope of appellate review is necessarily limited, and the findings of the trial judge must stand unless clearly erroneous.[204] Diversity of result among trial courts will tend to be lessened, however, "since there may be a natural tendency of professional triers of fact to follow one another's determinations, even as to factual matters."[205]

In accord with these principles, the Supreme Court reversed the Sixth Circuit in *Duberstein* because the conclusion of the Tax Court that the transfer of the Cadillac was not a gift was not clearly erroneous.[206] In *Stanton*, the Court found that the district court's unelaborated finding that the transfer was a gift was so sparse and conclusory that it was impossible to determine whether the finding was clearly erroneous. The Court therefore vacated the judgment of the Second Circuit in *Stanton* and remanded to the district court for further proceedings.[207]

Justice Frankfurter, in an opinion concurring in *Duberstein* and dissenting in *Stanton*,[208] pointed out that the Court had granted certiorari in *Duberstein* and *Stanton* primarily on the government's urging that, in the interest of better administration of the income tax laws, clarification was desirable in determining when a transfer was a gift.[209] Consequently, Justice Frankfurter criticized the majority for missing an opportunity to provide useful guidance to lower courts:

> What the Court now does sets fact-finding bodies to sail on an illimitable ocean of individual beliefs and experiences. This can hardly fail to invite, if indeed not encourage, too individualized diversities in the administration of the income tax law. I am afraid that by these new phrasings the practicalities of tax administration, which should be as uniform as is possible in so vast a country as ours, will be embarrassed.[210]

Although Justice Frankfurter conceded that the statute does not "easily yield to the formulation of a general rule or test," he argued that "greater explicitness is possible in isolating and emphasizing factors

203. *Id.* at 290.
204. *Id.* at 290-91.
205. *Id.* at 290.
206. *Id.* at 291-92.
207. *Id.* at 292-93.
208. *Id.* at 294-98 (Frankfurter, J., concurring in part and dissenting in part).
209. *Id.* at 294-95 (Frankfurter, J., concurring in part and dissenting in part).
210. *Id.* at 297 (Frankfurter, J., concurring in part and dissenting in part).

which militate against a gift in particular situations."[211] In Justice Frankfurter's own view, a transfer in a business context is presumptively not a gift while a transfer within the family is presumptively a gift.[212] In accord with this formulation, Justice Frankfurter would have decided against Duberstein and Stanton because neither had rebutted the presumption that the transfers, both made in a business context, were not gifts.[213]

B. *The Statutory Problem and the Prior Cases*

Although it was interpreting language in an act passed by Congress, the Supreme Court in *Duberstein* was writing on a relatively clean slate.[214] Congress's use of the general word "gift" and its failure to define or limit it gave the Court reasonable freedom to fashion its own definition. Furthermore, since the legislative history revealed no specific purpose for the exclusion,[215] any result reached by the Court necessarily could not be inconsistent with a discernible congressional purpose.

Of the possible holdings available to the Court in *Duberstein,* the following three appear to be the soundest solutions to the problem of assigning meaning to the word "gift" in the exclusion.[216] First, the Court might have defined the term "gift" colloquially, as it did, on the ground that in the absence of legislative guidance, a word in a statute should be interpreted in its ordinary, everyday sense.[217] Second, the

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211. *Id.* at 295 (Frankfurter, J., concurring in part and dissenting in part).

212. *Id.* at 296 (Frankfurter, J., concurring in part and dissenting in part).

213. *Id.* at 297-98 (Frankfurter, J., concurring in part and dissenting in part).

214. The only constraint on the Court was its own prior decisions, which, by granting certiorari in *Duberstein,* the Court was presumably willing to reconsider. *See id.* at 294-95 (Frankfurter, J., concurring in part and dissenting in part).

215. The Court's view that the legislative history of the exclusion for gifts is not illuminating is supported by an excellent article written a few years after *Duberstein* was decided. Klein, *An Enigma in the Federal Income Tax: The Meaning of the Word "Gift,"* 48 Minn. L. Rev. 215, 229-38 (1963).

216. Two other holdings are possible, but not persuasive. The Court might have defined "gift" in the common-law sense of any voluntary transfer made with donative intent. But this definition would be too generous to taxpayers. *See* Blum, *Motive, Intent, and Purpose in Federal Income Taxation,* 34 U. Chi. L. Rev. 485, 490-91 (1967). See *infra* text accompanying notes 225-27. Professor Klein suggests a fifth approach: "[A] court could consistently adopt the theory that the income tax should be used to accomplish various social objectives such as relieving from taxation persons thought to be needy. The term 'gift' might be construed, then, to encompass transfers made for charitable purposes, judged as objectively as possible." Klein, *supra* note 215, at 260-61. Professor Klein points out some problems with this theory. *Id.* at 260 n.205. The theory is also unpersuasive because the conjunction of the word "gift" with "bequest, devise, or inheritance" in the statute means that at a minimum the typical intra-family donative transfer should be treated as a gift even if the recipient is himself quite wealthy. See *infra* text accompanying notes 220-21.

217. *See* Klein, *supra* note 215, at 261. See *supra* text accompanying note 194.

Court might have held that since no discernible purpose for the exclusion could be found, the exclusion should be construed as narrowly as possible. In so holding the Court would have implicitly accepted the theory of some economists that the ideal of a tax on accretions depends on a broad definition of income,[218] a theory that seems to have formed the basis of the Supreme Court's then recent decision in *Commissioner v. Glenshaw Glass Co.*[219] Third, the Court might have said that the term "gift," especially when used in conjunction with the words "bequest, devise, or inheritance" in the statute, suggests a family or other close, personal relationship.[220] The Court consequently might have established rebuttable presumptions that a transfer within a family is a gift whereas a transfer in a commercial context is not a gift.[221]

One scholar suggests[222] that the Court chose the first alternative because it was the most consistent with *Bogardus v. Commissioner*,[223] the leading precedent decided by the Supreme Court. But the opinion in *Duberstein* is in fact inconsistent with *Bogardus* in two of its aspects. As the dissent in *Bogardus* noted, the majority in that case relied heavily on the absence of legal or moral consideration on the part of the recipient as support for its holding that the transfer was a gift.[224] In this respect the majority in *Bogardus* comes close to adopting the common-law notion that a gift is any voluntary transfer made with donative intent.[225] The Supreme Court in *Duberstein* specifically refused to import this notion into the income tax exclusion,[226] quite properly because it could open the door to tax avoidance by enabling businessmen to mask compensatory payments to employees and others by treating them as "voluntary" transfers made with donative intent.[227] Furthermore, *Bogardus* held that the question of determining when a transfer is a gift is a question of law or at least a mixed

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218. Klein, *supra* note 215, at 260. *See generally* H.C. Simons, *supra* note 13, at 41-58 (discussion of the definition of income).

219. 348 U.S. 426 (1955). The Court in *Glenshaw Glass* held that punitive damages were taxable because Congress intended "to tax *all* gains except those specifically exempted." *Id.* at 430 (emphasis added).

220. For the full text of § 102, see *supra* note 185.

221. Griswold, *supra* note 41, at 89; *see* Klein, *supra* note 215, at 261.

222. Klein, *supra* note 215, at 262.

223. 302 U.S. 34 (1937).

224. *Id.* at 44-45.

225. The majority in *Bogardus* emphasized that the transferor was "under no obligation, legal or otherwise" to make the transfer and that the transfer was "entirely lacking the constraining force of any moral or legal duty as well as the incentive of anticipated benefit of any kind." *Id.* at 41.

226. See *supra* text accompanying note 194.

227. Professor Blum has observed that the issue in *Duberstein* is not donative intent in the common-law sense, but "how large a degree of the commercial element is compatible with a gift under the income tax exclusion." Blum, *supra* note 216, at 492.

question of law and fact,[228] whereas the Supreme Court in *Duberstein* held that the question is "basically one of fact" on which the trial judge might be reversed only if his judgment was clearly erroneous.[229] Indeed, the five-to-four decision in *Bogardus*, which reversed the trial court's finding that the transfer was not a gift,[230] would likely have gone the other way under the "clearly erroneous" standard adopted in *Duberstein*.[231]

A respect for the principle of stare decisis, then, does not explain the result in *Duberstein*. Why the Court decided as it did is unclear, especially in light of the persuasive advocacy of Justice Frankfurter for the establishment of rebuttable presumptions.[232] What *is* clear is that the Court, by rejecting the second and third alternatives, reached a result that was very costly for the legal system.

C. *Economic Analysis of* Duberstein

1. The Inefficiency of *Duberstein*

The Supreme Court stated in *Duberstein* that decisions in cases involving the meaning of the word gift "must be based ultimately on the application of the fact-finding tribunal's experience with the mainsprings of human conduct to the totality of the facts of each case."[233] The transaction costs of this approach are very high indeed. By making every fact relevant, the Court invites the taxpayer to gather and produce evidence on every facet of his relationship with the transferor. If, for example, the taxpayer dined with the transferor regularly, or their children played together, or their spouses belonged to the same beach club, these facts might be relevant in determining whether a particular transfer was a gift. When the taxpayer and the government are required to produce and discuss a multitude of facts in settlement negotiations, when both parties are induced to produce this evidence at trial, and when the fact-finder has to evaluate and weigh each of these facts, transaction costs are considerable.[234]

Also costly is the fact that the outcome of litigation depends on the fact-finder's subjective judgment about the facts of each case. Contrary to the Court's optimistic view that diversity of result will lessen over time,[235] predicting the outcome of litigation is very difficult

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228. 302 U.S. at 39.
229. 363 U.S. at 290-91.
230. The dissent in *Bogardus* took the position that the question was one of fact and therefore would have affirmed the trial court. 302 U.S. at 45.
231. 363 U.S. at 289 n.11.
232. See *supra* text accompanying notes 208-13.
233. 363 U.S. at 289.
234. See *supra* text accompanying notes 101, 116.
235. Professor Klein argues that judges will inevitably reach results in this area in accord with their own value system:

> In an area such as taxation, different judges are likely to hold deeply seated values that conflict to a greater or lesser extent with the values held

under a nebulous standard such as that endorsed by the Court in *Duberstein*. This is especially so when application of the standard has been entrusted to numerous judges in the Tax Court and the federal district courts and to juries that sometime serve as fact-finders in federal income tax cases.[236] Because the probable outcome of litigation is unpredictable, negotiations will be protracted and costly, and litigation, which is generally more expensive than settlement, more likely.[237]

Another inefficiency of the *Duberstein* doctrine is that the legal system is missing an opportunity to build a capital stock of knowledge that can be used in later cases, for under the Court's mandate the precedential value of each fact-oriented decision is limited.[238] Lastly, waiting for Congress to provide more precise guidelines on the meaning of the word gift, as the *Duberstein* Court suggested, may also be inefficient.[239] In any event, if it really sought legislative guidance, the Court, instead of muddling through the language of old precedents, should have articulated a clearly defined and novel rule that Congress would find difficult to ignore.

2. The Efficiency of Justice Frankfurter's Presumptions

The adoption of rebuttable presumptions, such as those endorsed by Justice Frankfurter, represents a relatively inexpensive solution to the gift dilemma. By making it clear that one of the parties has a heavy burden to overcome the presumption against him, that party must concentrate on gathering and producing evidence strong enough to rebut the presumption. He would be well-advised, therefore, to be more selective about the facts that he discusses during settlement negotiations and tries to introduce at trial because the quality, not the quantity, of his evidence is more likely to be effective in rebutting the

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> by other judges. In these circumstances the results in individual cases may reflect an implicit rejection of the arbitrary rule in favor of the judge's own view of the proper goals of taxation. In other words, judges can be expected to strive constantly to "make sense" out of a statute, in terms of their own value system. This apparently has happened in the gift cases.

Klein, *supra* note 215, at 263.

236. That consistency among so many diverse triers of fact is a vain illusion is well illustrated by a recent case involving the issue of whether a hospital resident was entitled to exclude, as a fellowship under § 117 of the Code, stipends received from a university hospital. Mizell v. United States, 663 F.2d 772 (8th Cir. 1981). Despite the overwhelming number of prior cases denying the fellowship exclusion for hospital residents, the Eighth Circuit affirmed a jury verdict that the taxpayer qualified for the fellowship exclusion. In upholding the jury verdict, the court relied heavily on the Supreme Court's decision in *Duberstein*. *Id.* at 777.

237. See *supra* text accompanying notes 102-03, 109-14.

238. See *supra* text accompanying note 118.

239. See *supra* notes 119-25 and accompanying text.

presumption.[240] More importantly, a rule that places a heavy burden of proof on one of the parties will reduce the number of disputes between taxpayers and the government because parties with the burden are likely to realize in many cases that their chances for success are slim. Fewer disputes mean reduced transaction costs of negotiations and litigation. In addition, since a presumption makes the outcome of potential litigation more certain, settlement negotiations will be less time consuming and costly litigation less likely.

3. An Imaginary Supreme Court Opinion

Duberstein presented the Supreme Court with a golden opportunity to fashion a legal rule that would be both consistent with the statutory language and administratively and judicially efficient. Instead, the Court promulgated an opinion filled with sonorous, but nebulous, language that provided little guidance to lower federal courts. What is most puzzling about *Duberstein* is that the Court seems to have been somewhat aware of the economic implications of legal rulemaking, for the Court apparently granted certiorari in order to clarify the meaning of the word gift "in the interest of the better administration of the income tax laws."[241] Indeed, the opinion in *Duberstein* itself reveals a certain sensitivity to cost factors. In rejecting the government's proposed test and the presumptions on which it depends, the Court emphasized that some of the presumptions would be difficult—and presumably costly—for the trial court to apply.[242] Similarly, by holding that the judgment of the trial judge should be reversed only if it was "clearly erroneous," the Court spared the legal system significant costs of appellate litigation.[243]

Still, the Court reached a result in *Duberstein* that was very costly for the legal system. With an even greater understanding of the economic implications of its decision, the Court might have written an opinion along the following lines:

> The federal courts have been asked once again to decide whether a particular transfer qualifies as a gift under the exclusion for gifts in section 102(a) of the Internal Revenue Code. This issue has always been a matter of contention. The statute gives us little guidance as to the meaning of the word "gift"; the legislative history even less. Given the dearth of legislative guidelines on this question, it is not surprising that we find ourselves able to defend any of three results. We might construe the exclusion very narrowly

240. Arguably, some taxpayers will react to the presumption against them by trying to gather more, not less, evidence. At trial, however, the court may refuse to admit evidence that is not relevant to rebutting the presumption.

241. 363 U.S. at 294 (Frankfurter, J., concurring in part and dissenting in part).

242. *Id.* at 288-89.

243. See *supra* note 116.

on the grounds that it has no discernible purpose behind it; we might define the word "gift" in its colloquial, everyday sense and let the trial courts decide each case based on their experience with the mainsprings of human conduct; or we might imply in the word "gift" a family relationship and establish presumptions that a transfer within the family is a gift while a transfer in a commercial context is not a gift.

We take the presumption route. This result is perfectly consonant with the statute since the conjunction of the word "gift" with the terms "bequest, devise, or inheritance" in the statute suggests a family relationship. A great virtue of this approach is that it will enable the courts to decide most of these cases quickly and expeditiously. This will save the entire legal system—and the taxpayers who support it—a great deal of money. We understand that by establishing these presumptions we give some taxpayers a smaller chance of qualifying for a gift exclusion,[244] but the first solution would be even less favorable to taxpayers and the second would be tremendously burdensome, administratively and judicially. We recognize the right of Congress to deal differently with this problem, if it chooses. Until and unless Congress acts, we choose a result that is consistent with the statute we now have and which is efficient in terms of minimizing administrative and judicial costs.

IV. Recommendations

A. *Avoid Multifactor Tests*

An income tax rule that requires an evaluation of all or of a large number of facts is inevitably very costly.[245] Admittedly, in some areas of the federal income tax it may be impossible to limit judicial inquiry to fewer facts because analysis of only one or two facts cannot serve, in a fair and reasonably accurate way, as a surrogate for an evaluation of all the facts in reaching a decision.[246] Thus, before replacing a multifactor or an omnifactor test with a test that turns on one or two key issues, a court must determine whether the cases under the statutory provision in question are—or are likely to be—sufficiently homoge-

244. This proposed change from the *Duberstein* approach to a presumption rule is an example of a change in the law that makes everyone better off *ex ante*, but will make some people better off and some people worse off in the future. Specifically, the recipient of a gift in a commercial context in the future is likely to be worse off as a result of the change. Since, however, everybody benefits *ex ante*, rational persons would choose the presumption rule because the odds are that they will benefit from that choice. *Cf.* Tullock, *supra* note 14, at 663 (law of torts).

245. See *supra* notes 101-03, 109-11, 115-18, 234-38 and accompanying text. For a criticism on administrative grounds of a recent Supreme Court opinion for emphasizing twenty-six, fact-specific criteria in a particularly troublesome area of tax law, see Wolfman, *The Supreme Court in the Lyon's Den: A Failure of Judicial Process*, 66 Cornell L. Rev. 1075, 1100 n.128 (1981).

246. See *supra* text accompanying notes 104-08.

neous so that a simple rule will do substantial justice in the vast majority of cases.[247] If the factual situations are expected to be fairly uniform, the court then must be able to identify one or two common issues that may serve as accurate surrogates for a more extensive factual inquiry.

Because a surrogate rule raises the specter of possible injustice in individual cases, it is important that the rule be perceived as fair and accurate in the large majority of cases. Otherwise, the costs of perceived unfairness or inaccuracy may exceed the benefits of the simpler rule. With that qualification, a court should opt for a surrogate rule over a multifactor test even though the surrogate rule may harm some taxpayers. Indeed, if the cost savings of a surrogate rule exceed the costs of its occasional inaccuracy and unfairness, a rational taxpayer would choose the surrogate rule over a multifactor test *ex ante* even though he runs the risk of being one of those taxpayers harmed by the rule in the future.[248]

B. *Eschew Inquiries into a Taxpayer's Motive or Purpose*

Legal scholars have attacked income tax rules that require a court to ascertain the taxpayer's motive or purpose behind a particular transaction. One scholar has argued, for example, that the presence (or absence) of a tax avoidance motive is irrelevant in many instances to deciding how to tax a particular transaction.[249] Instead, courts should determine tax liability based on objective facts rather than on the taxpayer's subjective motive. Another scholar points out that purpose is often a difficult, elusive and ambiguous concept.[250] In cases in which a taxpayer's purpose has changed over time, it is hard to know the point at which a taxpayer's purpose is determinative.[251] Then, too, a taxpayer may have a variety of reasons for engaging in a particular activity; if so, it may be unclear whether having the desired (or forbidden) purpose is alone sufficient or whether that purpose must be a "significant" or "principal" purpose for engaging in the transaction.[252]

Inquiries into motive are often costly as well as difficult. Confronted with an income tax rule that necessitates the ascertainment of

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247. *See generally* Ehrlich & Posner, *supra* note 103, at 268-70 (analysis of the social costs resulting from over- or underinclusive legal rules).

248. See *supra* note 244.

249. Gunn, *Tax Avoidance*, 76 Mich. L. Rev. 733 (1978).

250. Klein, *supra* note 143, at 1107-12.

251. See *supra* note 142 and accompanying text.

252. *See, e.g.*, United States v. Generes, 405 U.S. 93, 103-05 (1972) (bad debt is fully deductible only if the taxpayer's "dominant" motivation was business rather than investment); Malat v. Riddell, 383 U.S. 569, 571-72 (1966) (per curiam) (exclusion from capital asset definition applies only if the taxpayer's "principal" purpose was sale to customers in the ordinary course of a trade or business).

motive, a court finds itself between the Scylla of placing great weight on the taxpayer's own testimony and the Charybdis of undertaking an independent inquiry into the taxpayer's motive. If the court were to limit its inquiry to the taxpayer's testimony, judicial costs would be relatively low: The court would hear his tale, gauge his credibility, and base its decision on its intuitive reaction to him and his saga. Not surprisingly, courts are rarely satisfied solely by the taxpayer's own testimony,[253] which may be biased, self-serving, even mendacious—and yet convincing if the taxpayer happens to be a persuasive advocate. The court's usual[254] alternative is to determine and weigh all the objective facts that bear on the taxpayer's purpose, in addition to hearing testimony from the taxpayer himself. The transaction costs of such an inquiry are high for the same reason that a multifactor test is costly: It requires the parties to gather and produce—and for the court to evaluate—evidence on virtually every objective manifestation that may reflect on the taxpayer's purpose.[255] In summary, since purpose-oriented income tax rules are at times irrelevant, often ambiguous and almost always costly, courts should adopt, whenever possible, rules that avoid inquiry into a taxpayer's actual subjective purpose.[256]

C. *Minimize the Stakes in Controversy*

A reduction of the stakes in controversy in a legal dispute increases the probability that the parties will settle rather than litigate.[257] Furthermore, reducing the amount that hinges on the outcome of litigation makes it more justifiable for a court to avoid the costs associated with an all-or-nothing test by adopting a surrogate rule in its stead.[258]

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253. Blum, *supra* note 216, at 503-05.

254. Professor Blum has noted that a court, in applying a rule nominally dependent on the taxpayer's state of mind, might base its judgment on methods of analysis different from ascertaining the taxpayer's actual subjective purpose. *Id.* at 496. A court may, for example, classify the taxpayer's action by judging whether it resembles more closely one activity or another, or more closely fits one function as compared to others ("comparative relatedness test"). *Id.* at 496, 501-03. Insofar as these analytical methods avoid the costs of an inquiry into all the facts of the taxpayer's case, they are economically preferable methods of applying a nominally purpose-oriented test.

255. See *supra* text accompanying notes 142-43.

256. The recent case of Mattes v. Commissioner, 77 T.C. 650 (1981), is illustrative. There the court allowed a taxpayer to deduct the cost of a hair transplant operation as a medical expense under § 213(e) of the Code even though the taxpayer conceded that the operation was undergone for purely cosmetic reasons. In so holding, the court emphasized that the expense was for a medical procedure to correct a specific physiological condition. Thus, the court focused on the objective nature of the expense, which was wholly medical, rather than on the taxpayer's subjective motive in incurring the expense.

257. See *supra* notes 111-13, 145-46 and accompanying text.

258. See *supra* text accompanying note 134.

One scholar has urged[259] that the deductibility of transportation expenses of a combination business and pleasure trip should not turn on the result of an all-or-nothing test, but instead should be subject to an allocation, based on objectively determinable facts, between the portion of the expenses attributable to business and thus deductible and the portion of the expenses attributable to personal consumption and thus nondeductible.[260] Although the transaction costs of making this allocation may be high, rules that minimize the stakes in controversy reduce total transaction costs by generating fewer legal disputes, by minimizing the costs of negotiations and by increasing the likelihood that the parties will settle rather than litigate.

D. *Require Substantiation*

A central feature of the federal income tax system is that it relies primarily on self-assessment and voluntary compliance by taxpayers. Although taxes must be withheld on certain forms of income,[261] each taxpayer essentially determines his own tax liability. A political asset of a self-assessment system is that citizens in a democracy participate directly in what is a fundamental, albeit onerous, duty of citizenship. Self-assessment also minimizes the monetary and social costs of raising a large amount of revenue under an income tax. To begin with, voluntary compliance by taxpayers enables the system to function at a substantially reduced cost to government and, indirectly, to the taxpayers whose taxes support the system. Although the costs to taxpayers in their individual capacities may be higher,[262] a self-assessment system is almost surely less expensive overall because taxpayers have less costly access than the government to the information necessary to determine properly their income tax liability.[263] Moreover, the alternative to a system of voluntary compliance may be a system of direct assessment by the government, which by comparison could be excessively bureaucratic, intrusive and inquisitorial.[264]

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259. Klein, *supra* note 143.

260. Ordinary and necessary business expenses are deductible; personal, living or family expenses are not deductible. I.R.C. §§ 162(a), 262 (1976).

261. *See, e.g., id.* § 3402(a) (1976) (employer required to withhold tax on wages).

262. See *supra* notes 170-72 and accompanying text.

263. See *supra* note 177 and accompanying text.

264. The early income tax in Germany involved a system of direct assessment which, though successful in raising revenue, was criticized by scholars and others on the grounds that it was bureaucratic and inquisitorial. *See* E.R.A. Seligman, *supra* note 183, at 262-65, 270-72. Indeed, one of the strongest objections throughout the nineteenth century to the adoption of an income tax was that it would be an intrusive and inquisitorial tax. *Id.* at 280-83 (France), 500-01 (the United States Income Tax of 1894), 659. For a modern, constitutional perspective on the potential for abuse by government in the federal income tax system, see Berger, *"Voluntary" Self-Assessment? The Unwilling Extraction of Taxpayer Information*, 42 U. Pitt. L. Rev. 759 (1981).

The success of a self-assessment system hangs, however, on the delicate thread that taxpayers are reasonably honest in computing their tax liability. Ensuring the honesty of taxpayers depends on taxpayer perception that cheating does not go unpunished and on taxpayer confidence that other taxpayers are paying their fair share of taxes. Income tax rules that permit taxpayers to receive deductions or tax credits without documentation undermine the system in both respects, making it difficult to prove conclusively that a taxpayer has cheated and highlighting for honest taxpayers the fact that dishonest taxpayers are able improperly to reduce their tax liability.[265] Approximation rules also increase the chance of intrusive and inquisitorial tactics by government officials who, without documentation of a claimed deduction or credit, may be compelled to inquire more deeply into the taxpayer's personal affairs.[266] By contrast, a rule requiring a taxpayer to provide evidence in support of his deductions not only obviates the government's need to audit in many cases, but also reduces its incentive to pry excessively when it does audit.[267]

E. *Adopt Presumptions, Safe Harbors and Per Se Rules*

A legal rule that establishes a presumption for or against the taxpayer or the government,[268] a rule that opens a safe harbor within which a taxpayer may plan with impunity,[269] a per se rule that makes a transaction taxable (or not) regardless of the factual context,[270] all are usually economically efficient rules. By limiting the number of relevant factual issues, these rules minimize the costs of negotiation and litigation. In addition, they reduce the likelihood of legal dispute and the chance that the parties will engage in costly litigation.[271]

Legislative rulemaking of this type is more common than judicial rulemaking,[272] in part because some judges regard such rulemaking as

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265. See *supra* notes 167-69 and accompanying text.

266. See *supra* source cited in note 174 and accompanying text.

267. See *supra* text accompanying note 178.

268. *See, e.g.*, I.R.C. § 183(d) (1976) (activity presumed to be "engaged in for profit" if the activity produced a profit two or more taxable years out of five taxable years).

269. *See, e.g.*, *id.* § 334(b)(2) (1976) (distribution treated as in partial liquidation of a corporation, thereby qualifying for capital gain or loss treatment, if certain specific conditions are met).

270. *See, e.g.*, United States v. Davis, 397 U.S. 301, 307-13 (1970) (redemption of stock held by a sole shareholder always "essentially equivalent to a dividend").

271. See *supra* text accompanying notes 240-41.

272. For an excellent study of evolutionary patterns within the law of corporate taxation that confirm this insight, see Clark, *supra* note 6. Professor Clark points out that the almost universal pattern of development in corporate taxation is for a taxpayer to develop a tax avoidance scheme, for a court to enunciate an open-ended doctrine to combat the perceived abuse, and finally for Congress to preempt the field with detailed and mechanical statutory rules. *Id.* at 94-135.

a legislative function and in part because some judges are reluctant to add detailed rules to an already complex and compendious statute like the Code.[273] But judicial decisions that adopt either a per se rule or presumption avoid considerable costs in the application and administration of federal income tax law, without necessarily violating the language of the statute or a discernible legislative purpose.[274] Courts, therefore, ought to be receptive to per se rules or presumptions whenever a general or imprecise statutory provision generates frequent, time-consuming and expensive litigation.[275]

F. *Avoid Rules that are Traps for the Unwary*

An aphorism of federal income tax law states that Congress and the courts should not promulgate rules that operate as "trap[s] for the unwary."[276] Imposing a tax on an uninformed taxpayer that can be avoided by a well-informed or well-advised taxpayer seems to discriminate unfairly between similarly situated taxpayers. Moreover, if the system values a rule so little that it allows taxpayers to escape its sting by careful tax planning, the rule is economically inefficient since it induces taxpayers to incur otherwise unproductive transaction costs in order to avoid the rule.[277]

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273. *See id.* at 95-96.

274. See *supra* text accompanying notes 234-44.

275. Although judicial pronouncements tend generally to be less specific than the Code, see *supra* note 272, the Supreme Court has occasionally adopted rules that are more mechanical than the relevant statutory language in order to quiet a particularly turbulent area of tax law. In United States v. Davis, 397 U.S. 301 (1970), the Court faced the recurring and vexatious issue of whether a redemption of stock in a closely held corporation is taxable as a dividend, which may give rise to ordinary income, I.R.C. §§ 301, 316 (1976), or as a capital gain. 397 U.S. at 303-04. Prior to *Davis*, the issue had been litigated frequently, primarily because of the general statutory language under which taxpayers claimed capital gains treatment and the government argued for ordinary income treatment. I.R.C. § 302(b)(1) (1976). A line of cases had allowed a "sole shareholder" capital gains treatment on a redemption if he could establish that the redemption was devoid of a tax avoidance motive and was supported by a business purpose. 397 U.S. at 303 n.2. The Supreme Court in *Davis* reduced the stream of litigation on this question in three ways. First, it explicitly rejected the prior purpose-oriented test. *Id.* at 312. Second, it promulgated a per se rule that the redemption of stock of a sole shareholder is *always* essentially equivalent to a dividend. *Id.* at 307. Finally, the Court stated that in all other cases the only relevant factual issue is whether the redemption resulted in a meaningful reduction of the taxpayer's interest in the corporation. *Id.* at 313.

276. *See, e.g.*, McWilliams v. Commissioner, 331 U.S. 694, 702 (1947).

277. Section 1031 of the Code is a dramatic example of a statutory provision that generates unproductive transaction costs. Section 1031(a) provides for nonrecognition of gain or loss on the exchange of "like-kind" assets, with some exceptions, used in a trade or business or held for investment. Under this provision courts have held that a taxpayer does not qualify for nonrecognition treatment if he sells an asset and then reinvests the proceeds of the sale in a like-kind asset; to qualify for nonrecogni-

Despite the aphorism, some important features of the federal income tax in fact cause serious economic misallocations of this type. High marginal tax rates, for example, lead upper income taxpayers to embrace tax shelters in order to reduce their effective tax rates.[278]

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tion an actual exchange of like-kind assets must occur. *See, e.g.*, Bloomington Coca-Cola Bottling Co. v. Commissioner, 189 F.2d 14 (7th Cir. 1951).

Courts have, however, allowed taxpayers to satisfy the exchange requirement by careful tax planning. *See, e.g.*, Alderson v. Commissioner, 317 F.2d 790, 794 (9th Cir. 1963); J.H. Baird Publishing Co. v. Commissioner, 39 T.C. 608, 615 (1962). In a common scenario, B may own a tract of undeveloped real estate that A would like to acquire in return for a piece of vacant land owned by A. A offers to exchange his land for B's tract, but B refuses because he prefers cash to A's land. Although A could sell his land on the market and use the proceeds to buy B's land, he would have to recognize gain on the sale. As a result, A finds C who is willing to be a middleman between A and B. A transfers his land to C on the strength of C's promise to acquire and transfer B's property to A. C sells A's land on the market and uses the proceeds to buy B's land, which C then conveys to A. The net effect of these transactions is that A has B's land, B has his cash, and C, the willing broker, has nothing (except, perhaps, a fee for his services). More importantly, since A has actually *exchanged* his property with C for a like-kind asset, A receives nonrecognition treatment.

Although A has accomplished his primary tax objective, § 1031 and the judicial decisions under it clearly generate an efficiency loss. Were A able to receive nonrecognition treatment by selling his property and reinvesting the proceeds in a like-kind asset, transaction costs would be relatively low because only two transactions—a sale on the market by A of his land and a purchase by A of B's land—would take place. Current law, by contrast, makes A incur additional costs in locating C and in convincing him to serve as the middleman. This induces the parties to engage in three, rather than two, transactions: (1) a sale by C on the market of land that was formerly A's; (2) a purchase by C of B's land; and (3) an exchange between C and A.

Congress should address this efficiency problem. If Congress concludes that the underlying purpose of § 1031 requires that *both* parties to the exchange have had a genuine prior investment in like-kind property, Congress could bolster that purpose by requiring for nonrecognition treatment that both parties have held a like-kind asset for a minimum period of time before the exchange occurs. Such a requirement would preclude a taxpayer from satisfying the exchange requirement through the intervention of a third party who acquires a like-kind asset solely for the purpose of an immediate exchange.

If, as is more likely, Congress concludes, in accord with judicial opinions, that a taxpayer is entitled to nonrecognition treatment so long as he continues his investment in like-kind property, Congress should enact a provision that would enable a taxpayer to get nonrecognition treatment even on a sale so long as he reinvests the proceeds in a like-kind asset within a fixed period of time. Such a provision would spare the system the otherwise unproductive transaction costs that a well-advised taxpayer now incurs in satisfying the exchange requirement of § 1031. For an analogous provision under current law, see I.R.C. § 1034 (1976) (gain on the sale of a principal residence not recognized if taxpayer purchases another principal residence within two years).

278. If government cares strongly enough about the sanctity of high marginal rates, it can, of course, take vigorous legislative or administrative action to prevent taxpayers from avoiding the rates by investing in tax shelters. *See, e.g.*, I.R.C. § 465 (1976) (taxpayer allowed to deduct a loss only up to the amount "at risk" in certain investments, primarily tax shelters). But the fact that a large number of taxpayers are

These shelters not only consume economic resources in their creation and management, but often generate less pre-tax income than more productive, competing investments.[279] Thus, in addition to the transaction costs of creating and managing tax-avoidance plans, the system suffers a further efficiency loss if the activities fostered by these plans would not take place in the market—or would take place to a lesser extent—without the benefit of tax subsidy.[280] The courts and Congress therefore ought to be wary of any income tax rule that generates an efficiency loss either by causing taxpayers to incur transaction costs in avoiding the rule or by inducing taxpayers to purchase relatively unproductive—but tax-favored—investments.[281]

CONCLUSION

This Article has illustrated the contexts in which courts may use efficiency criteria to help decide troublesome cases in federal income taxation. Admittedly more numerous, however, are income tax cases that should not be decided on the basis of efficiency criteria: when, for example, the statutory language is unambiguous; when the legislative purpose is clearly expressed; or when an overriding and conflicting tax policy goal, such as fairness or redistribution, is at stake. But this Article has shown that in some areas, the adoption of alternatives to current income tax rules may be desirable from the standpoint of both efficiency *and* fairness. Moreover, whenever a court's decision will affect primarily the administration of a statutory provision rather than its substance, cost minimization would be an important—often the determinative—criterion of income tax rulemaking. Finally, the

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still allowed to avoid high marginal rates through tax shelter plans may be a good indication that society is ambivalent about the wisdom of high rates, in which case it would be more efficient simply to reduce the rates. Of course, it may be that the *pretense* of redistribution is consoling even when the *reality* is different. *See* H.C. Simons, *supra* note 13, at 219. To some extent Congress has responded to this problem by reducing the maximum rate on investment income from 70% to 50%. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 101, 95 Stat. 172, 176-82; S. Rep. No. 144, 97th Cong., 1st Sess. 23 (1981).

279. The investor nevertheless purchases the tax shelter because his net after-tax return on his investment in the shelter exceeds the net after-tax return he would get on a fully-taxed investment.

280. See *supra* notes 96-100 and accompanying text.

281. Congress, of course, may make a conscious choice to subsidize a particular activity by giving it an indirect tax subsidy even though, or perhaps because, the activity is relatively unproductive. Whether Congress should use the tax system indirectly to subsidize an activity or should provide a direct subsidy instead has been debated by leading tax scholars. *Compare* Bittker, *Accounting for Federal "Tax Subsidies" in the National Budget*, 22 Nat'l Tax J. 244 (1969) *with* Surrey, *Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures*, 83 Harv. L. Rev. 705 (1970).

language of the Code is occasionally so vague or imprecise, and the underlying legislative purpose so uncertain, that frequent and costly litigation inevitably results. These circumstances usually justify judicial adoption of a rule that will minimize the costs of legal dispute resolution so long as that rule violates neither the language of the statute nor a discernible legislative purpose.