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CODIFYING JUDICIAL DOCTRINES: NO CURE FOR RULES BUT MORE RULES?*

Steven A. Bank**

TAX law has often been criticized as too insular and self-absorbed.¹ This is unavoidable in most circumstances given the complexity of the Internal Revenue Code (the “Code”) and the speed with which it changes. Nevertheless, the failure to borrow and learn from other disciplines is a missed opportunity to shed new light on familiar questions. One such familiar question is the rules versus standards debate in tax law. This debate has heated up of late in part because of government efforts to codify the judicial doctrines of business purpose and economic substance as a weapon against the problem of corporate tax shelters. In *Tax Shelters, Tax Law, and Morality: Codifying Judicial Doctrines*,² Professor Ellen Aprill does a great service by suggesting that we pause to explore the corporate tax shelter codification debate from the broader philosophical and jurisprudential perspective of the debate over rulemaking generally.

To provide this broader perspective, Aprill calls upon Professor Frederick Schauer’s well-known work on the benefits of rule-based decision-making, *Playing by the Rules: A Philosophical Examination of Rule-Based Decision-Making in Law and in Life*.³ As Aprill explains, Schauer hardly touches upon the tax laws in this “philosophical examination” of rules.⁴ Not surprisingly, therefore, only a handful of tax scholars have even cited Schauer’s work in their articles,⁵ and it appears that none have used it to

* Cf. KARL N. LLEWELLYN, *THE BRAMBLE BUSH* 108 (1930) (“No cure for law but more law”).

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1. See, e.g., Paul L. Caron, *Tax Myopia, or Mamas Don’t Let Your Babies Grow up to be Tax Lawyers*, 13 VA. TAX REV. 517, 589 (1994).

2. Ellen P. Aprill, *Tax Shelters, Tax Law, and Morality: Codifying Judicial Doctrines*, 54 SMU L. REV. 9 (2001).

3. FREDERICK SCHAUER, *PLAYING BY THE RULES: A PHILOSOPHICAL EXAMINATION OF RULE-BASED DECISION-MAKING IN LAW AND IN LIFE* (1991). Larry Alexander has called Schauer the “lord of one of jurisprudence’s most important territories, that of the characteristics of posited rules and posited rules’ relations with morality.” Larry Alexander, *Can Law Survive the Asymmetry of Authority?*, in *RULES AND REASONING: ESSAYS IN HONOUR OF FRED SCHAUER* 39, 39 (Linda Meyer ed., 1999).

4. Aprill, *supra* note 2, at 11.

5. See Edward A. Morse, *Reflections on the Rule of Law and “Clear Reflection of Income”*: *What Constrains Discretion?*, 8 CORNELL J.L. & PUB. POL’Y 445, 453 n.33 (1999);

analyze how best to address the problem of corporate tax shelters. Given the extent to which the rules versus standards debate will inform any attempt to shut down corporate tax shelters, this omission is unfortunate.

I. SCHAUER'S PRESUMPTIVE POSITIVISM

Schauer's work examines the difficulties that arise when strict observance of a rule conflicts with the rule's underlying justifications,⁶ a problem lying at the heart of the discussion about tax-motivated corporate transactions that follow the letter, but not the spirit, of one or more provisions of the Code. As Aprill explains, Schauer quickly rejects the two extreme positions for resolving this dilemma: either always or never referring to a rule's justification in applying the rule.⁷ In the former, which Schauer calls "particularistic" decision-making because it focuses only on the particular circumstances at issue, the rule becomes so malleable that it loses much of its predictive force.⁸ In the latter, which Schauer calls "rule-based" decision-making because it focuses primarily on the rule to the exclusion of the particular circumstances,⁹ the rule becomes so rigid that it grows distant from its underlying justification. Schauer instead suggests that the gap between the application of a rule in a given case and the underlying justification for the rule is resolved through some intermediate form of decision-making that combines the need to refer to the underlying generalization with the need to follow a set of rules.

Schauer considers two possible intermediate positions between particularistic and rule-based decision-making in addressing the divergence between rule and generalization. Schauer calls the first, which he ultimately rejects, "rule-sensitive particularism."¹⁰ Under this method, substantive justifications may override rules, but only after they are first balanced against rule-generating justifications such as predictability, reliability, and certainty.¹¹ According to Schauer, the problem with this method is that it fails to adequately take into account the operation of rules as "devices for the allocation of power."¹² Rule-based decision-making operates to cabin the discretion of rule appliers to look beyond the rules to their underlying justifications in situations when, because of a distrust of the rule

Deborah L. Paul, *The Sources of Tax Complexity: How Much Simplicity Can Fundamental Tax Reform Achieve?*, 76 N.C. L. REV. 151, 166 n.65 (1997); Alice G. Abreu, *Untangling Tax Reform: Simple Taxes, Complex Choices*, 33 SAN DIEGO L. REV. 1355 (1996); Laura Cunningham, *Use and Abuse of Section 704(c)*, 3 FLA. TAX REV. 93, 124 n.62, 1417 n.171 (1996); James W. Colliton, *Standards, Rules and the Decline of the Courts in the Law of Taxation*, 99 DICK. L. REV. 265, 265 n.1 (1995); Gwen Thayer Handelman, *Sisters in Law: Gender and the Interpretation of Tax Statutes*, 3 UCLA WOMEN'S L.J. 39, 60 n.95 (1993); John A. Miller, *Indeterminacy, Complexity, and Fairness: Justifying Rule Simplification in the Law of Taxation*, 68 WASH. L. REV. 1, 2 n.5 (1993).

6. See SCHAUER, *supra* note 3, at 72.

7. Aprill, *supra* note 2, at 12; SCHAUER, *supra* note 3, at 51.

8. SCHAUER, *supra* note 3, at 77.

9. *Id.* at 78.

10. *Id.* at 97.

11. See *id.* at 94-97.

12. *Id.* at 98.

applier or because of the jurisdictional design of the system, a grant of such discretion is not warranted.¹³ It is more than simply balancing the substantive justification against the traditional benefits of expressing something in the form of a rule. Thus, Schauer's conclusion is that the existing rule-making structure is best described as exemplifying what he calls "presumptive positivism."¹⁴ Decision-makers presumptively follow rules, tending to override such rules only in "particularly exigent circumstances."¹⁵ This, according to Schauer, preserves the benefits of rule-based decision-making as a method of allocating power, while not committing the "sin of rule-worship."¹⁶

Aprill primarily draws upon three aspects of Schauer's description of rule-based decision-making in her examination of corporate tax shelters: (1) the close connection between a rule and its justification, (2) the traditional benefits of predictability, reliability, and certainty that are associated with rules, and (3) the ability of positivist decision-making to cabin the discretion of a rule-applier to diverge from the rules where, because of distrust or jurisdictional design, such an allocation of authority would be imprudent.¹⁷ Aprill suggests that the codification debate can be understood as a debate about whether the judiciary or the Service should decide when a rule should be trumped by its underlying justification. While that question has traditionally been resolved in favor of the judiciary because of our distrust of the Service, Aprill concludes that such distrust may be unwarranted. Aprill calls for the use of Schauer's analytical framework to study the issue further.

II. THE PERILS OF PRESUMPTIVE POSITIVISM AS OUR GUIDE

One initial problem with Aprill's discussion, engendered perhaps by the limited nature of this forum, is her failure to justify the narrow focus on Schauer's description of decision-making. Aprill is correct in suggesting that Schauer provides an important starting point for any discussion of the attempt to shut down corporate tax shelters. To suggest that Schauer provides a starting place for the topic does not, however, establish that he provides the final word as well. Although *Playing By the Rules* is already considered a classic in the field,¹⁸ Aprill does not argue that it is the consensus or dominant account of rule-based decision-mak-

13. See *id.* at 98-99.

14. SCHAUER, *supra* note 3, at 196.

15. *Id.*

16. *Id.* at 98.

17. See Aprill, *supra* note 2, at 12-13. Aprill also considers a fourth aspect of Schauer's description of the process of rule-making—the possibility of errors that occur because of the nature of the party entrusted with the responsibility of determining when a justification should override its rule—that essentially overlaps with the separation of powers analysis. See *id.*

18. Alexander, *supra* note 3, at 39, 40 (calling *Playing by the Rules* "the locus classicus" for the field).

ing among jurisprudence scholars.¹⁹ Indeed, it would be difficult to make such a claim. Entire symposia have been devoted to criticisms of Schauer's work in this area,²⁰ and, as Aprill herself notes, there are many other, sometimes contradictory, descriptions of the rule-making process from authors of equal or greater prominence.²¹ Schauer admits that he has not, and perhaps could not, "prove the descriptive accuracy of presumptive positivism."²² While the recent focus on Schauer's *Playing by the Rules* reflects the persuasive force of its description, it also highlights its controversial nature.

Other descriptive theories of decision-making, if applied to the codification question, might lead us to different conclusions. For instance, critical legal theorists might describe our current system as one in which rules are merely symbolic constraints on the decision-maker. In such a system, the decision to override a rule in favor of its justification may be based on instrumental concerns unrelated to the justification itself. Aprill concedes that one weakness in Schauer's account is its failure to explain how decision-makers identify a rule's justifications.²³ A critical legal theorist might suggest that this is because decision-makers pick and choose "justifications" that support their decision to ignore a rule in a particular case. Codification of the judicial doctrines would therefore only serve to provide heightened cover for the politics of corporate tax shelters.

This alternative result suggests that one could agree with Aprill's premise that the consideration of the corporate tax shelter debate will be aided by studying rule theory without concluding ultimately that Schauer is the theoretician to guide us in the exercise. Perhaps this is all that Aprill intends to accomplish in her paper. Aprill does not undertake to advocate or defend Schauer's description or to reject other possible accounts of decision-making. This point, therefore, is more of a caveat to the reader than a substantive criticism of the work. ...

A related point is that even if Schauer correctly describes the current system from the point of view of the behavior of rule-makers and rule-appliers, it is not clear why this perspective is relevant. Corporations and their advisers may be convinced, contrary to Schauer's account, that the decision to go after tax shelters is based on more than simply the existence of a rule and its underlying justification. Given the Service's relatively limited enforcement resources and resolve, such a conclusion may not be unwarranted. Codification would do little to fundamentally alter the behavior of participants in corporate tax shelters if the traditional

19. See Aprill, *supra* note 2, at 14.

20. For an example of such symposiums, see, e.g., RULES AND REASONING: ESSAYS IN HONOUR OF FRED SCHAUER (Linda Meyer ed., 1999) (containing papers presented at a conference at Quinnipiac Law School); *Symposium on Law and Philosophy*, 14 HARV. J.L. & PUB. POL'Y 615 (1991) (containing papers presented at the Conference on Rules and the Rule of Law at the University of San Diego School of Law).

21. See Symposium on Law and Philosophy, *supra* note 20 (citing accounts from scholars such as Posner and Dworkin).

22. SCHAUER, *supra* note 3, at 204.

23. See Aprill, *supra* note 2, at 14.

benefits of rules are considered to be, by and large, illusory in this area. Aprill recognizes the saliency of this point when addressing the practitioner's lack of confidence in the application of the judicial doctrines in corporate tax shelter cases,²⁴ but she neglects to make an affirmative case for the perceived benefit of rules in the administrative arena. In fact, Aprill's only examples on this score—the enactment of a statutory anti-abuse rule in section 482 and codification of the business purpose requirement under Section 355—only highlight the fact that the rules themselves either produced or failed to resolve uncertainty. As Aprill herself notes, section 482's regulations have gone through numerous revisions over the years and now consume almost 100 pages. Yet, they still fail to offer predictability or a solution to the recent corporate tax shelter schemes. Section 355's history tells a similar tale. The final Section 355 regulations were issued after lengthy deliberation in 1989,²⁵ but the eventual need for additional guidance in the form of Revenue Procedure 96-30 demonstrates that the rule failed to measure up to the traditional rule-generating justifications. As one practitioner noted, under the Section 355 regulations, "[t]he determination of whether an adequate business purpose exists can be quite subjective."²⁶ It took an additional rule to clear up the first rule, but even after the issuance of Revenue Procedure 96-30, Section 355's business purpose requirement is hardly free from uncertainty.²⁷

A far more fundamental problem with Aprill's optimistic conclusion may be that Schauer's description of decision-making *does* accurately reflect practitioner belief about the system. If, instead of doubting the Service's resolve to adhere to the letter of its rules, practitioners expect the Service to adhere to its rules in literal fashion in all but the most exigent of circumstances (or, contrary to Schauer's description, to adhere to them in all cases), we should be wary of any effort toward codification of the judicial doctrines. The adoption of more rules may be seen as an invitation to structure a transaction that strictly complies with the letter of such rules, but only loosely, if at all, comports with the underlying justification.

In fact, presumptive positivism may explain a long history of failed attempts to resolve "leaky" tax laws with more laws. Rules have begat more rules with little effect on tax avoidance. Consider, for example, the original provisions governing tax-free reorganizations. The earliest Revenue Acts, especially those adopted during and soon after World War I, were drafted hastily and without much practical experience to serve as

24. See Aprill, *supra* note 2, at 16 ("A belief that judges often fail to weigh sufficiently the Big Three justifications for rules (certainty, predictability and reliance) lies at the heart of most critiques of cases that apply the judicial anti-abuse standards.")

25. See Aprill, *supra* note 2, at 30-33 (collecting sources).

26. Louis A. Panoutsos, *Rev. Proc. 96-30 Provides Guidance on Sec. 355 Business Purpose*, 27 TAX ADVISER 526, 526 (1996).

27. See, e.g., Burgess J. W. Raby & William L. Raby, *Spin-Off Business Purpose: Corporate or Shareholder?*, 97 TAX NOTES TODAY 227-45 (Nov. 25, 1997) (noting the problem of distinguishing between corporate and shareholder business purposes, especially in the context of family-owned businesses, for purposes of Section 355).

precedent.²⁸ Not surprisingly, Congress's inability to focus on detail resulted in statutory provisions that often left both taxpayers and government officials frustrated and confused. Although the Revenue Act of 1921 included what, according to Randolph Paul, "the Congress then thought were comprehensive reorganization provisions," taxpayers soon took advantage of the many deficiencies and gaps in drafting.²⁹ After extensive study, Congress concluded in 1924 that the relatively sparse reorganization provisions should be greatly expanded to specify the exact nature of each requirement for qualifying under the statute.³⁰ The subsequently enacted Revenue Act of 1924, along with its reorganization provisions, was called "the most detailed and precise statutes which had been evolved up to that time."³¹ As Paul remarked, the provisions "on their face appeared sufficient to capture the most elusive quarry."³² It was such a radical departure from the level of detail in the prior Revenue Acts that a comprehensive description and explanation of the proposed changes from the Revenue Act of 1921 consumed almost two full pages of the *New York Times*.³³ Authored by A.W. Gregg, a special assistant to the Secretary of the Treasury, the "Gregg Statement," as it came to be known, became a symbol for a style of drafting that favored leaving nothing unsaid.³⁴

Within a decade after its adoption, the problems engendered by the 1924 Act's detail-oriented approach became readily apparent. Creative tax lawyers located loopholes in even the most explicit of clauses, while Treasury was hamstrung by its apparent presumptive positivism in reading the statute. As a consequence, "defeat piled upon defeat."³⁵ By 1933, many were ready to abandon the rules approach. A House Ways and Means subcommittee complained that "the abuses under the present policy far outweigh the advantages . . . the provisions of the present law are very involved, difficult to understand, and particularly hard to interpret in the light of actual cases as they arise."³⁶ Citing eight examples in which the tax laws were being used to evade taxes, the subcommittee recommended abolishing the tax-free reorganization altogether.³⁷

28. See Charles D. Hamel, *The Joint Congressional Committee on Internal Revenue Taxation*, 5 NAT'L INCOME TAX MAG. 161, 161 (1927).

29. RANDOLPH E. PAUL, *STUDIES IN FEDERAL TAXATION: THIRD SERIES* 37 (1940).

30. See *id.*; Hugh Satterlee, *The Income Tax Definition of Reorganization*, 12 TAX MAG. 639, 640 (1934).

31. Valentine Brookes, *The Continuity of Interest Test in Reorganizations – A Blessing or a Curse*, 34 CAL. L. REV. 1, 5 (1946).

32. PAUL, *supra* note 29, at 37.

33. See *Treasury Expert Explains Tax Bill*, N.Y. TIMES, Jan. 5, 1924, at 1, 8-9.

34. See Satterlee, *supra* note 30, at 640.

35. PAUL, *supra* note 29, at 37.

36. SUBCOMM. OF THE HOUSE COMM. ON WAYS AND MEANS, *PRELIMINARY REPORT ON PREVENTION OF TAX AVOIDANCE*, 73d Cong., 2d Sess., Exh. D (Comm. Print 1933), reprinted in 100 U.S. REVENUE ACTS 1909-1950, at 37, 38 (Bernard D. Reams, Jr. ed., 1979).

37. *Id.* at 8, 39-41.

The Treasury Department echoed the subcommittee's criticisms of the detail and complexity of the tax laws. In a statement issued regarding the subcommittee report, Treasury noted that "[t]he reorganization provisions are, as the subcommittee states, perhaps the most complicated and difficult to understand of any sections of the law. In addition to their complexity, they are open to the serious objection of being over-specific."³⁸ Treasury placed much of the blame on the tendency to overstate the advantages of predictability and understate the inability to prevent evasion in such a rigid system.³⁹ Rather than advocating the elimination of the tax free reorganization, it favored, as Aprill explains in her discussion of this issue,⁴⁰ the adoption of general provisions that would place the onus on Treasury to guard against abuse, by issuing rules and regulations to address situations as they arose.⁴¹ This proposal, however, was subject to some of the same objections as the Gregg Statement approach. George Grayson Tyler, a former assistant to Roswell Magill during his tenure at Treasury, and John Ohl, a staff member in the Treasury Secretary's general counsel's office, conceded that Treasury's proposed alternative "would have been effective in plugging certain loopholes, but soon the regulations would have become even more specific than the present statutory provisions It would always be claimed that the regulations did not conform to the 'general plan' as expressed in the statute."⁴²

Congress rejected the suggestions of both the subcommittee and Treasury, choosing to plug the holes in the old rules with a plethora of new rules. The Revenue Act of 1934 resulted in a reorganization provision "which reached an all-time peak in completeness and verbosity."⁴³ To practitioners, the 1934 Act appeared to be an attempt to "make it possible, under that and subsequent laws, to follow the literal meaning, without looking to such vague considerations as 'underlying assumptions and purposes.'⁴⁴ Nevertheless, it was far from a self-executing act in part because of the tendency of taxpayers to take advantage of its specificity in

38. STATEMENT OF THE ACTING SECRETARY OF THE TREASURY REGARDING THE PRELIMINARY REPORT OF A SUBCOMM. OF THE HOUSE COMM. ON WAYS AND MEANS RELATIVE TO METHODS OF PREVENTING THE AVOIDANCE AND EVASION OF THE INTERNAL REVENUE LAWS TOGETHER WITH SUGGESTIONS FOR THE SIMPLIFICATION AND IMPROVEMENT THEREOF, 73D CONG., 2D SESS. 9 (Comm. Print 1933), *reprinted in* 100 U.S. REVENUE ACTS, *supra* note 36 [hereinafter STATEMENT OF THE ACTING SECRETARY].

39. *See id.* ("When they were adopted in 1924, the draftsmen attempted to state in minute detail exactly how each step of a reorganization should be treated for tax purposes. Although this method had the apparent advantage of enabling taxpayers and their lawyers to determine in advance exactly how proposed transactions would be taxed, it had the disadvantage of leaving the Department no leeway in the administration of the law.")

40. *See* Aprill, *supra* note 2, at 33.

41. *See* STATEMENT OF THE ACTING SECRETARY, *supra* note 38, at 10.

42. George Grayson Tyler & John P. Ohl, *The Revenue Act of 1934*, 83 U. PA. L. REV. 607, 625 (1935).

43. PAUL, *supra* note 29, at 38.

44. Robert N. Miller, *Income Tax Liability in Reorganizations*, 14 TAX MAG. 131, 134 (1936).

devising avoidance schemes.⁴⁵

In this downward spiral of rules, the *Gregory* case⁴⁶ served as a welcome life preserver.⁴⁷ Although many practitioners bitterly complained that the opinion in the case was overreaching and vague,⁴⁸ they grudgingly recognized that it might be more effective than legislative and administrative rulemaking efforts in stopping tax avoidance.⁴⁹ One commentator noted that, "though it renders certainty or predictability impossible, [the *Gregory* case] does present a potentially effective means of preventing tax avoidance."⁵⁰ Others recognized that alternative methods of plugging the gaps were much slower and, even if they started out as general principles, would eventually devolve into detailed and complex (and therefore avoidable) provisions in the hands of the Service.⁵¹ Treasury's Tyler and Ohl concluded that "the probability is that in the future the courts will be more effective than the draftsmen in prohibiting the more flagrant cases of tax avoidance."⁵² Such predictions proved to be true. Soon after *Gregory* was decided, Treasury attempted to codify the business purpose doctrine by promulgating regulations much like the ones proposed in connection with the corporate tax shelter issue today. The first relatively narrow attempt was broadened considerably beyond the *Gregory* case itself as Treasury struggled to capture its "elusive" meaning, but the regulations appear to have played a minor role at best in actually forestalling tax avoidance.⁵³ Some believe that it was removal of a tax on the distribution of appreciated assets in *General Utilities*⁵⁴ that did the most to stem the tax avoidance risk from reorganizations.⁵⁵

Our experience with the reorganization provisions suggests that Aprill has primarily addressed only one-half, and probably the less important half, of the question. Rather than a question of which group, the judiciary or the Service, can be trusted with the decision to override a rule, the real question is whether the avoidance occurring under our current rules can be prevented by issuing more rules. Aprill's focus is understandable given that practitioners have been very vocal in their complaint that over-

45. See Steven A. Bank, *Federalizing the Tax-Free Merger: Toward an End to the Anachronistic Reliance on State Corporation Laws*, 77 N.C. L. REV. 1307, 1325-27 (1999) (describing the litigation resulting from the insertion of the statutory merger requirement).

46. *Gregory v. Helvering*, 293 U.S. 465 (1935).

47. See PAUL, *supra* note 29, at 38-39.

48. See, e.g., Satterlee, *supra* note 30, at 689 (complaining that the business purpose requirement was potentially "all embracing, like a London fog"); Robert N. Miller, *Corporate Reorganizations: The Present Situation*, 12 TAX MAG. 459, 461 (1934).

49. There were some dissenters on this point, although even they conceded that the problem was the overspecificity of the statute. See Milton Sandberg, *The Income Tax Subsidy to "Reorganizations"*, 38 COLUM. L. REV. 119, 125 (1938).

50. Comment, *Corporate Reorganization to Avoid Payment of Income Tax*, 45 YALE L.J. 134, 140 (1935) (citations omitted).

51. See J. Bay Robinson, *Determining Income Tax Liability by the Taxpayer's Motives*, 12 TAX MAG. 402, 404 (1934); Tyler & Ohl, *supra* note 42, at 625.

52. Tyler & Ohl, *supra* note 42, at 626-27.

53. See PAUL, *supra* note 29, at 133-34.

54. *Gen. Utils. & Operating Co. v. Helvering*, 296 U.S. 200 (1935).

55. See Tyler & Ohl, *supra* note 42, at 626.

reaching on the part of the Service will put a crimp on legitimate tax planning, but, as Professor David Weisbach points out, tax planning hardly merits much of our interest.⁵⁶ We should now ask what presumptive positivism, or whatever theory accurately describes rule-based decision-making, tells us about codification's likelihood to resolve the corporate tax shelter problem. Only then can we assess whether there really is no cure for the deficiencies of rules but more rules.

56. David Weisbach, Letter to the Editor, *It's Time to Get Serious About Shelters*, 88 TAX NOTES 1677, 1677 (2000) (“[T]hose who worry about an overly broad anti-shelter doctrine are concerned about ‘legitimate tax planning.’ But what cost should we bear to protect tax planning? Very little.”).

