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THE BUSINESS PURPOSE DOCTRINE AND THE SOCIOLOGY OF TAX

*Joseph Bankman**

I. PRACTICE

SOME time ago, an English professor at Stanford's Academic Senate rose to denounce the disparity in salaries between law professors and humanists. "If you don't think you're paid enough," responded my late colleague John Kaplan, "why don't you just quit and practice English."

The relative opportunities in the private sector and the academy explain a lot about the scope of both practice and scholarship. Law professors, unlike English professors, can get a job outside of the academy, and their pay scale gives evidence as to that other opportunity. But the differential in outside opportunity between the law and humanities is reproduced, in lesser form, within the legal academy. Scholars in subjects such as constitutional law, law and society, or jurisprudence can practice law, but the practice is apt to be tangential to their intellectual interests. Academia is really the only game in town worth playing. Not so for those interested in tax. In tax one can practice one's core field. And the qualities prized in academia – smarts and a scholarly nature—are also prized in tax practice. In litigation or even corporate law, personality is king, and the most successful lawyers are often those whose main strengths are interpersonal. In tax, it is the substance that counts.

The result is a tax bar that is, from an academic standpoint, unparalleled. The leaders of the tax bar are as productive, in terms of scholarship, as many of us in academia. They play a leading role in legal reform. And in terms of raw intellectual horsepower, well, it is hard to imagine a more impressive group in practice or academia.

Ask anyone who has been in the field to name the list of leading practitioners and the same names pop up. There's _____, and _____, and _____. Peter Canellos is one of those names. My guess is that if you played along with this mental exercise and compiled a list that didn't include Mr. Canellos, you'll readily admit the omission was merely an oversight. In his contribution to this volume, *A Tax Practitioner's Perspective on Substance, Form and Business Purpose in Structuring Business Transactions and in Tax Shelters* ("Business Purpose"), Mr. Canellos gives us a practi-

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tioner's view of the tax shelter phenomenon. There is much that is useful and smart in *Business Purpose*. In keeping with the thrust of this essay, however, I want to pick up one point Mr. Canellos makes. Tax practice, he writes, can be divided into two bars: the tax bar and the tax shelter bar. Tax bar lawyers are transactional; they structure "real" deals. These deals cut across categories and doctrines, and so tax bar lawyers are of necessity generalists. They are comfortable with a world in which rules sometimes give way to standards. Reputation is important for members of the tax bar, and leadership roles in organizations such as the New York State Bar Association serve both as a marker and maker of that reputation. Lawyers in the tax shelter bar, in contrast, deal with artificially contrived deals and more are comfortable with rules rather than standards. Their deals are accompanied by opinions that are designed as selling points or insurance against audit penalties; no one in the know, writes Mr. Canellos, takes these opinions seriously. The opinion writers lose (or never have) professional reputation. Perhaps for this reason, Mr. Canellos tells us, "It is inconceivable that a practitioner who specialized in tax shelters would ever reach a position of responsibility in [the New York State Bar Association and similar] organizations."¹

No generalizations are without counter-examples, and my guess is that both Mr. Canellos and I could name a few individuals who are closely associated with shelter promoters and who nonetheless play or at least have played a significant role in government and/or professional associations. For the most part, however, Mr. Canellos has identified a key split in the tax world. Most members and leaders of the New York State Bar Association regard the shelter phenomenon as deplorable. They are often asked to advise clients on shelters but do not have what most of us would describe as a shelter practice. This side of the tax bar would readily push the (alas, nonexistent) button that would eliminate the "modern" shelter, even if so doing would deprive them of this slight part of their current practice.

Inspired or at least egged on by Mr. Canellos' example, I want to propose two other generalizations about shelters and the tax world: young versus old and accountants versus lawyers. Before doing so, I want to make an apology in advance for those who will find themselves mislabeled in my schema. The generalizations I propose are accurate, if at all, only in the aggregate. Many young lawyers will find themselves not at all well described by the "young" in my generalization; the same is true of my treatment of the members of the other broad categories. On the whole, though, I believe my generalizations are accurate and tell us something about the subject of this symposium.

That said, let's begin with old versus young. The "senior" lawyers are between 45 and 65. They are, in broad outline, comfortable with stan-

1. Peter C. Canellos, *A Tax Practitioner's Perspective on Substance, Form and Business Purpose in Structuring Business Transactions and in Tax Shelters*, 54 SMU L. REV. 47 (2001).

dards. In part, this comfort has been acquired through practice. Members of this group, particularly the older members, began their career at a time when the tax law had far fewer rules, and the tax practitioner was more of a generalist. Legal education may have also played a role in shaping attitudes on the rules versus standards debate. This group attended law school at a time during which textualism was associated with long-vanquished formalism. Shining stars of the academy fell somewhere between the intentionalists and the purposivists on the continuum of statutory interpretation.

In contrast, junior members of the tax bar inherited a practice that was more specialized and rule-bound. The detailed regimen set up by the original discount rules, or §704(b) regulations, came into existence or had just been adopted during their tenure. The first task of many lawyers in this cohort was to learn and explain rules which their most senior partners hoped to retire without mastering. Law school, too, was different for this group. The list of leading jurists, whose opinions students study and to whom students apply to for clerkships, included textualists such as Scalia and Kolinski. The textualist, or more broadly described, formalist approach was represented in the academy by the writings of Scalia, but also by the work of a number of other scholars, such as Amar.²

There appears to be a political manifestation of the age gap. Though the new textualism or formalism has adherents on the left as well as right, the movement is in general conservative in impulse. The movement is closely tied to broader conservative political movements, which have grown in strength during the past few decades. The Federalist Society, a small fringe group when I was a student at Yale Law School in the 1970's, has for some years been one of the largest and most active student organizations. I think it is safe to say that the Federalist Society blends a restricted approach to statutory interpretation with a conservative political philosophy. An earlier generation of law students witnessed first-hand or a few years removed, the Civil Rights movement, which relied upon expansive reading of text to achieve many of its goals. For many members of this cohort, a non-textual, standards-based reading of text is associated with liberal goals in issues of race and gender; and both are favored. The political differences extend to the use of the tax system to redistribute wealth from top to bottom, seen with increasing disfavor by each cohort of law students and young lawyers.

The above schema suggests that broad "pro-government" judicial doctrines such as business purpose or economic substance should be more popular with senior than junior lawyers, and I believe that to be the case. In the past few years, I have spoken on the subject of tax shelters at insti-

2. See generally, Antonin Scalia, *A MATTER OF INTERPRETATION: FEDERAL COURTS AND THE LAW* (1997), Akhil Reed Amar, *Altainder & Amendment 2: Romer's Rightness of Romer*, 95 U. MICH. L. REV. 203 (1996). My description of the academy here, and my use of the term formalism, is taken from Thomas C. Grey, *The New Formalism* (unpublished manuscript).

tutes and conferences, and I've gotten a substantial number of practitioner responses to writings in this area. Virtually everyone I've ever heard from or spoken with over the age of 60 supports the government's position in cases such as *ACM P'ship v. Comm'r*.³ The level of support drops directly, and dramatically, with age. It may be that junior members of the bar will change their position as they grow older—that the fuzziness of standards will seem more acceptable as the years pass, and one's experience grows. My own guess is that this will occur, but only to a small extent. The doctrines that many of us support (however reluctantly) today will not be supported with anywhere near the same enthusiasm by tomorrow's leaders of the tax bar.

Of much greater significance than the difference between junior and senior is the difference between lawyers and accountants. If there is a generation gap between junior and senior lawyers, interpretively speaking, there is an absolute chasm between lawyers and accountants. Accountants, like lawyers, are everywhere confronted with close questions. And there are instances aplenty in which the accounting profession has argued for standards over rules, particularly in cases in which the rules are thought draconian. Consider, for example, the recent flap over the relationship between the audit and consulting functions within an accounting firm. Is an accounting firm that sells substantial consulting or tax services to a client too biased to audit the client's financial statements? SEC Chair Arthur Levitt says "yes, or possibly yes" and recommends the ultimate bright line rule as remedy: the split-off of the auditing from other functions. The accounting profession argues that the particular rule is overbroad and no rule is required.⁴

In general, though, the impulse in accounting is to resolve difficult issues with rules rather than standards. Indeed, where standards are supported over rules, it is generally not because standards are thought superior, but because the particular rules proposed are thought wrong-headed. The broad, standards-based jurisprudence incorporated in the business purpose doctrine jibes awkwardly with the rule-leaning accounting profession.

Lawyers think in a self-conscious way about statutory interpretation and are willing to wade through abstruse academic language to get a better handle on the subject. Not long ago, a journal published by the American Bar Association, *The Tax Lawyer*, published an article by Robert Thornton Smith on the subject of this symposium.⁵ In that article, Mr. Smith argues that "a theory-embedded approach to interpretation is . . . 'not only attractive but inevitable,'" and proposes a "constructive purposive" interpretive theory modeled closely on the jurisprudence of Ronald

3. *ACM P'ship v. Comm'r*, 157 F.3d 231 (3d Cir. 1998).

4. The debate is described briefly in Sandra Sugawara, *Accounting Rule in the Balance, Levitt Lobbying to Save Proposed Curbs on Firms' Consulting Work*, WASH. POST, Oct. 24, 2000, at E01.

5. Robert Thornton Smith, *Business Purpose: The Assault upon the Citadel*, 53 TAX LAW. 1 (1999).

Dworkin.⁶ Such an interpretive position, argues Mr. Smith, best explains and justifies the business purpose doctrine. Interpretation in tax is a much worked subject; many scholars, and I believe most lawyers, would shy away from the open-ended approach to interpretation associated with Dworkin.⁷ But if Mr. Smith's jurisprudence finds support from only a minority of lawyers, my guess is it finds support from virtually no accountants. Indeed—and this is the point—it is inconceivable that an article such as his would be published in any accounting journal.

In the tax shelter arena, at least, the differences between the two professions' positions on statutory interpretation have an economic basis, or at least is supported by the economics of the two practices. Lawyers, by and large, profit from shelters only indirectly when they are asked to evaluate shelters for clients. In the long run, shelters may be bad for the legal tax practice. They are often promoted by accounting firms, who compete with law firms for tax business. A customer who purchases tax products from an accounting firm may be more likely to move other areas of tax practice to the firm. Accounting firms, in contrast, are probably the primary purveyors of shelters today. Shelter sales produce million dollar fees and buoy up the tax departments of the big accounting firms. The disappearance of shelters would be a significant event for such firms.

The differing attitudes and professional roles of lawyers and accountants are reflected in their respective professional associations. Mr. Canellos tells us (correctly, I believe) that leading bar organizations are led by transactional, rather than tax shelter, lawyers. That those lawyers come from firms without significant shelter work goes without saying: as noted above, shelter work makes up only a small part of tax practice in most law firms. The accounting profession, in contrast, is dominated by a few large firms, all of whom, as noted above, earn substantial sums from shelter promotion. Professional associations in that field are necessarily dominated by those firms (though the members of those firms who serve may not themselves do shelter-related work). Predictably, given the intersection of self-interest and a rules-based interpretive theory, the accounting profession has been more supportive of the literal interpretations that underlie shelters and IS opposed to any extension of broad doctrines. Compare, for example, the New York State Bar and AICPA reports on shelter legislation.

If lawyers and accountants held stable shares of the tax marketplace, then the difference between the two groups, while perhaps of some interest, would not tell us anything about the future of the business purpose doctrine. The state of the law today would reflect the relative power of each group, and there would be no reason to believe the ratio of power held by the two groups would change in any direction. In fact, as most readers of this essay know, the market share of accounting firms has in-

6. *Id.* at 16.

7. See Joseph Bankman, *The Economic Substance Doctrine*, 74 S. CAL. L. REV. 5 (2000).

creased dramatically in recent years. Tax work is now much more likely to go to an accountant than a lawyer. With the growth of tax practice has come a shift in hiring patterns. Accounting firms have stepped up their hiring of young lawyers and have lured away a number of law firm partners. Significantly, this latter group consists for the most part of partners with high reputations within the tax community. At least one accounting firm has gone even further and gone into partnership with a tax law firm. It seems only a matter of time until accounting firms in this country are allowed to do what accounting firms in many other countries already do: practice law.

Of course, the trend toward an increasing role for accounting firms in tax practice may not last forever. Accounting firms, which have long been low-cost providers of tax advice, now list billing rates that are every bit as costly as a Wall Street firm. The erosion of a prior cost advantage may suggest a coming stabilization of market share. On the other hand, it may be taken as evidence that accounting firms have sufficient market power and reputation so as to be able to charge premium rates. And the fact that lawyers work for accounting firms does not mean that the lawyer's perspective is completely lost. Socialization is a two-way street. One might expect that just as lawyers who work for accounting firms absorb the culture of accountants, the traits and culture the lawyers bring with them will be absorbed by their non-legal colleagues. Tax court judges and members of tax-writing committees will still be lawyers, though perhaps lawyers who begin and/or end their career working for accounting firms.

Notwithstanding the above qualifications, one suspects that the tax profession will in the future speak with a more unified voice, and it will sound much like the present voice of the accounting profession. That does not bode well for interpretive doctrines such as business purpose or economic substance.

II. THE ACADEMY

In *The Common Knowledge of Tax Abuse*,⁸ Mark Gergen address the perennial issue of rules versus substance in tax jurisprudence. Along the way, Gergen isolates and discusses a methodological split among academics. One the one side, writes Gergen, is the "earlier" work of academics such as Gunn and Isenbergh (sorry, guys); the other is represented by a recent article by David Weisbach. Gergen's statement of the gap between them is so insightful and well-phrased that I repeat it below:

Gunn and Isenbergh's arguments are first and foremost arguments of tax law, and their normative criteria—the criteria of coherency, consistency, and clarity—are, in a sense, intrinsic to the law. Weisbach's argument is about tax law—it is about what form of tax law is most efficient. . . . In Weisbach's analysis, the value of coherency, consis-

8. Mark P. Gergen, *The Common Knowledge of Tax Abuse*, 54 SMU L. REV. 131 (2000).

tency, and clarity is entirely instrumental.⁹

For expositional purposes, we may call the Gunn and Isenbergh position an internal coherency approach, and the Weisbach position an efficiency/welfarist approach.

Gergen's essay is quite good and deserves discussion in its own right. Consistent with the theme of this essay, however, I want to add a bit to the portrait Gergen paints of tax scholarship. I have five comments or observations, all of which are related, and all of which, due to length constraints, are somewhat overbroad and underdeveloped. I believe my additions are consistent with the spirit of Gergen's essay, and state facts about which Gergen would agree, but on this I may be mistaken.

First, a review of the players: Gergen correctly identifies Weisbach as advocating an efficiency/welfarist approach to the rules versus standards debate and the tax law in general. Weisbach, however, is not alone in this regard. At least three other scholars—Louis Kaplow,¹⁰ Daniel Shaviro,¹¹ and Thomas Griffith—have explicitly or implicitly set forth similar views.¹² More generally, Weisbach's approach is at least correlated with a law-and-economics approach to the subject. My guess is that most scholars who hold a J.D./Ph.D in economics adopt this approach. More generally, the distinction between internal and instrumental approaches to law cuts across fields—and the steady turn to instrumentalism over the past thirty years is strongly correlated with, if not caused by, the colonization of the legal academy by law and economics scholars.¹³ I should confess here that I am a fellow traveler; readers should read into my comments whatever bias they think that affiliation with this group entails.

Second, a review of the ground on which the debate is held; this symposium is on the business purpose doctrine and so Gergen discusses the different ways in which the two sides view that doctrine and the related rules versus standards debate. In fact, the two sides differ at least somewhat in their approach to virtually all questions of tax policy. To take but one example, an efficiency/welfarist approach to the problem of the rate base, or the desirability of any deductions that might be seen as excep-

9. *Id.* at 143-44.

10. For a thorough exposition of Kaplow's welfarist ethics, see Louis Kaplow and Steven Shavell, *Principles of Fairness versus Human Welfare: on the Evaluation of Legal Policy*, Harvard Law School, John M. Olin Center for Law, Economics and Business, Discussion Paper No. 277 (2000), available at <http://www.law.harvard.edu/programs/olin-center/papers.htm>. For a representative application of that position to tax, see Louis Kaplow, *The Income Tax as Insurance: The Casualty Loss and Medical Expense Deductions and the Exclusion of Medical Insurance Premiums*, 79 CAL. L. REV. 1485 (1991).

11. See the welfarist analysis Shaviro gives the business purpose/economic substance issue in Daniel N. Shaviro, *Economic Substance, Corporate Tax Shelters, and the Compaq Case*, 88 TAX NOTES 221 (July 10, 2000).

12. See, Joseph Bankman & Thomas Griffith, *Social Welfare and the Rate Structure: A New Look at Progressive Taxation*, 75 CAL. L. REV. 1905 (1987).

13. In very recent years, a counter-trend has developed, back toward formalism and other forms of non-consequentialist argument. See note 1 and text accompanying that note. Time will tell whether this is just a small blip in a steadier, secular trend toward instrumental policy analysis. But blip or not, it has not been in evidence in tax.

tions to that base, looks quite different from an internal/coherency approach to the same issue.¹⁴

Third, at least in any given arena, one can always make assumptions that reconcile the two approaches. For example, a confusing and internally incoherent system may use up resources wastefully, and for that reason is found wanting under the efficiency/welfarist criteria. Those who follow the internal coherency approach are not blind or indifferent to welfare; and welfarists worry about the costs of confusion.

Fourth, while as noted immediately above, it is possible to reconcile the two approaches, the approaches are best seen as distinct. The approaches are built upon different assumptions, both normative and positive, and will often lead to different outcomes. Those who adopt the welfarist/efficiency approach seek to determine the effects of a particular tax provision or proposal on efficiency or welfare. Those who adopt an internal coherency approach are skeptical of the claim that we know enough about how the economy interacts with the tax law to make that calculation. To that extent, they challenge a positive assumption that underlies the welfarist/efficiency approach. Many are skeptical as well about the normative assumption that underlies the welfarist/efficiency approach: that efficiency or welfare is all that matters. Consider, for example, the belief that "likes should be treated alike" which serves as the basis for the concept of "horizontal equity." This belief seems generally consistent with values of internal coherency. My guess is that it and its instantiation in a system of horizontal equity is one of the desiderata of a tax system that is built on internal coherency. Thus, like treatment of likes is a value in itself. Followers of the efficiency/welfare approach regard "likes should be treated alike" as an empty tautology, and horizontal equity as of no independent value in setting tax policy.¹⁵

The efficiency/welfarist approach regards internal coherency-based scholarship as without normative force. Internal coherency scholarship can tell the welfarist something about the consequences of a particular provision, but until those consequences are tethered to an efficiency/welfare analysis, internal coherency scholarship cannot say anything about the desirability of that provision. Isenbergh's *Musings on Form and Substance in Taxation* is appropriately cited as a reflecting the values of internal coherency.¹⁶ It is a smart and elegantly worded article. It plumbs the logical difficulties with the holdings of the cases, and the business purpose doctrine in general. It offers an interesting observation about the beneficiaries of the business purpose doctrine,¹⁷ and the mindset of jurists who

14. See, e.g., Thomas D. Griffith, *Theories of Personal Deductions in the Income Tax*, 40 HASTINGS L. J. 343 (1989).

15. For example, see Louis Kaplow, *Horizontal Equity: Measures in Search of a Principle*, 42 NAT'L TAX J. 139 (1989).

16. Joseph Isenbergh, *Musings on Form and Substance in Taxation*, 49 U. CHI. L. REV. 859 (1982).

17. Tax lawyers. *Id.* at 884.

invoke the doctrine.¹⁸ But it does not provide a systemic analysis of the efficiency consequences of the doctrine.¹⁹ The lack of such analysis is presumably deliberate. Professor Isenbergh is writing in a casual, essayist style. The piece is ostensibly a review of another work, and the perspective from which he writes does not require that he tote up efficiency gains and losses or even speculate about how one might go about that task. The article therefore does not answer, or even seriously discuss, the bottom-line question the welfarist asks. Much the same could be said about *The Uneasy Case for Progressive Taxation*,²⁰ an earlier piece by (now deceased) colleagues of Mr. Isenbergh. It wickedly and insightfully attacks a particular position without exploring the positive effects or normative desirability of any alternative position. Neither piece gets to what any welfarist would regard as the nub of the issue: the consequences of tax rules.

Is there a winner in this battle? The reader can make her own conclusions as to the merits of the two positions. But as to the “market share” occupied by the two sides, I venture an opinion: the efficiency/welfarist group is somewhat in the lead. The younger cohort is solidly in this camp. (Law is an older person’s field, so “young” here is a term of art; it means ages 35 to 50). Those who cannot at least participate in the discourse of efficiency and welfare run the risk of being marginalized. But academic fashions come and go, and the next generation of tax scholars may resurrect the internal coherency approach, or come up with a new approach altogether. We who follow the call of welfare and efficiency will then be the fuddy-duddies, and it will be our work that is described in patronizing tones by the younger generation.

18. Judges who are bored with statutory interpretation wish to appear economically sophisticated, and believe that invoking (or helping create) broad doctrines will make them appear statesmanlike. *Id.* at 882.

19. For example, Isenbergh correctly describes time tax lawyers spent explaining the business purpose doctrine as an efficiency cost (that explains why tax lawyers in his view are the beneficiary of the doctrine). *Id.* at 884. But, he does not discuss the possibility that the doctrine might limit effort that would otherwise go into planning and carrying out transactions without social value. Similarly, Isenbergh states that legislation could cure any loopholes. He does not weigh the costs of the judicial doctrine against the costs of legislation. *Id.* at 881.

20. Walter J. Blum & Harry Kalven, Jr., *The Uneasy Case for Progressive Taxation*, 19 U. CHI. L. REV. 417 (1952). The article was published in book form the following year, Walter J. Blum & Harry Kalven, Jr., *THE UNEASY CASE FOR PROGRESSIVE TAXATION* (1953).

