

## Absurdist Humor and the Form-Substance Dialectic in Tax Law

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Comedian Bob Alper tells this story:

*Berman is known to like children. Berman is having his sidewalk repaved. Neighborhood children are playing outside Berman's house. One kid accidentally slides into the wet concrete. Berman verbally assaults the kid. Parent runs out and says, "Mr. Berman, I don't understand. I thought you liked children?" Berman says, "I do. But in the abstract. Not in the concrete."*

*The Wall Street Journal* tells this story:

*Legal advisers at a Big Four accounting firm create, recommend, and execute a plan — a transaction with important tax implications. Even though the plan may conform to the letter of the law, the government objects to the plan, and its results. The government says that the results were not achieved through a transaction with sufficient "substance" and is, therefore, an abuse of the tax laws. The government asserts that the form of the transaction must give way to the transaction's substance.*

The government, like Berman, is OK with the transaction in the abstract, but not in the concrete.

The U.S. Treasury disallows the claimed tax benefits, and the U.S. Justice Department then criminally charges the legal advisers.

The form-substance distinction has long been a philosophical, metaphysical, and jurisprudential conundrum. Get it wrong now, however, and the consequences may be worse than being the object of Berman's ill humor. Get it wrong, and you may be headed for the slammer.

### The Greeks Wrestle With the Problem

It may be little consolation, but today's indicted tax advisers are yesterday's would-be philosopher-kings. The form-substance distinction, the most vexing of problems in modern tax law, would have been familiar to the ancient Greeks as well as to Philo, Maimonides, and Thomas Aquinas.

Plato arrived at the conclusion that some abstractions, like mathematics, are reality-based, and therefore have substance. Moreover, Plato believed, those abstractions have a permanent essence. Those are called universal substances or Platonic Forms.

Aristotle was not so sure. In his *Metaphysics*, Aristotle attempted to classify things that had

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substance — for example, things that are known to the senses, such as bodies, animals, plants and their parts, elements, and compounds of elements and their parts; and things not known to the senses, including supra-sensible and eternal substances, like mathematics.

Aristotle agreed that some abstractions (forms) are reality- based and therefore capable of existence. However, he concluded that the essence of those abstractions may not be free-standing — rather, they are likely dependent on the understanding of other things. Aristotle believed that for a form to have substance, the substance must have some kind of definable essence. While defining essence is easier said than done, Aristotle was clear on this point: Essence had to be grounded in reality and in common sense. Aristotle recognized that a form could be described in such a way that its essence appears as an absurdity, much the way that it seems absurd to insist on describing an onion as such after it is peeled back to the core.

*A woman is wheeling her grandson in a baby carriage. A woman stops her. "What a beautiful baby," she says. "Ah, this is nothing! You should see his pictures."*

The illustration raises a second point (as coined by Alfred Korzybski): The map is not the territory. To think otherwise would negate the notion that form, substance, and essence, to have their stand-alone existence respected, must somehow work together in a way that is grounded in the real world. That applies to law. As Joseph Isenbergh explains, "In almost all statutes one finds an amalgam of references to the world and relations created by the statute itself; a mixture, if you will, of life and art."

A third point: Form and substance, to exist, must be in some important sense grounded in fact. In other words, the thing described must happen. The sham transaction doctrine holds that labels are not determinative. An arrangement can be ignored if the actors do not themselves act in accordance with the definitions, or mechanics, of the arrangement.

*In the early 1970s, Brezhnev announces to the Politburo that he is making a state visit to Poland and that he wishes to bring the Polish people a momentous gift. It is decided that Brezhnev should bring a large painting entitled "Lenin in Poland." After all, what could be a more meaningful expression of Soviet-Polish solidarity than a portrait of Lenin, the god of Soviet communism, visiting Poland? Unfortunately, Lenin never visited Poland, and the "great masters" of the Artists Union, their minds constricted by socialist realism, can come up with no ideas how to depict Lenin in Poland.*

*Time is running short, and the Soviet leadership is growing desperate. Finally it is decided to approach Rabinowitz, a dissident artist. "We know you have voiced many complaints against your country," a visiting KGB delegation tells him. "But if you perform this service for the motherland, we promise you a large apartment and a lot of work."*

*Rabinowitz agrees to make the painting of Lenin in Poland. Three weeks later, the day before the trip, Brezhnev leads a delegation of Politburo members into a conference room. There stands Rabinowitz in front of a large canvas covered by a dropcloth. "Let us see the painting," Brezhnev says.*

*Rabinowitz removes the covering, and everybody in the room gasps. The painting shows a man in bed with a woman.*

*"Who is that man?" someone shouts at Rabinowitz.*

*"That's Trotsky."*

*Another gasp.*

*"And who is the woman?" another Politburo member yells out.*

*"Krupskaya, Lenin's wife."*

"And where is Lenin?" Brezhnev thunders.

"Lenin's in Poland."

Had Aristotle lived today, would he have recognized modern legal forms? For instance, business entities — legal fictions whose form in part shapes and in part mirrors the behavior of economic actors? How about tax-minimizing transactions whose forms are otherwise correct and are grounded in economic reality? Aristotle likely would have attributed substance to those forms. But what measure would Aristotle have used in testing the validity of those transactions?

I suggest that Aristotle would not have used our so-called soft doctrines. He would have abandoned the business-purpose-involving-a-reasonable-possibility-of-profit doctrine, the economic-substance-beyond-the-creation-of-tax-benefits doctrine, the cannot-be-overly-motivated-by-tax-considerations doctrine, the does-it-objectively-affect-the-taxpayer's-net-economic-position doctrine, or the step transaction doctrine.

Aristotle, I think, would have used the comedy of the absurd doctrine. He would have looked to jokes for legal guidance.

### **The Hand Behind the Doctrine**

The substance over form doctrine is judge-made. The doctrine, first enunciated by Judge Learned Hand, holds that the tax authorities may disregard the form of a transaction to reach its substance. The goal of that effort is "to prevent the exploitation of unintended loopholes in tax statute and regulations."

In other words, we live in a legal world in which exist different ways (forms) of engaging in transactions with similar or common ends. Those ways can be taxed very differently. If what is done, fairly characterized, falls within the statute, but results in a "bad thing" — like "impermissible" tax avoidance — the transaction can be set aside.

Let's start with the celebrated case of *Gregory v. Helvering*. Judge Richard Posner summarizes the case:

Mrs. Gregory was the sole owner of a corporation that owned certain assets that she wanted to sell. If they were either sold directly or distributed to and then sold by her, there would be a large tax; for example, the distribution of assets to her directly would be treated as a dividend equal in amount to the value of the assets and would be taxable in that amount as ordinary income to her. So she formed a new corporation, also wholly owned by her, to which she had the old corporation transfer the assets in question. She then dissolved the new corporation, three days after having created it; received the assets as a liquidating dividend; and then sold them. Because the distribution of the assets to her had literally been pursuant to a "plan of reorganization," and because a liquidating dividend issued pursuant to such a plan is not a taxable dividend, she claimed to be liable only for a tax on the capital gain she reaped when she sold the assets. The Supreme Court held that the "reorganization" had been a sham and therefore Mrs. Gregory was not entitled to treat the distribution of assets pursuant to it as a liquidating dividend exempt from ordinary income tax.

It's interesting to review the judicial treatment of the facts. The Board of Tax Appeals held that despite the result, the statute defined what reorganization was, and reorganization was what had occurred:

As long as corporations are recognized before the law as if they were creatures of substance, there is nothing to distinguish "the newly-formed corporation" from enumerable others, whether they be devised to achieve a temporary tax reduction or some other legitimate end. Congress has not left it to the

Commissioner to say . . . that the corporate form may be ignored in some cases and recognized in others.

. . . .

. . . . A statute so meticulously drafted must be interpreted as a literal expression of the taxing policy, and leaves only the small interstices for judicial consideration.

The government appealed. The matter was heard by a panel including Judge Hand. The panel reversed, and Judge Hand's language continues to echo throughout the world of tax metaphysics:

We agree with the Board and the taxpayer that a transaction, otherwise within an exception of the tax law, does not lose its immunity, because it is actuated by a desire to avoid, or, if one chooses, to evade, taxation. Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes. . . . Nevertheless, it does not follow that Congress meant to cover such a transaction, not even though the facts answer the dictionary definitions of each term used in the statutory definition. It is quite true, as the Board has very well said, that as the articulation of a statute increases, the room for interpretation must contract; but the 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.

That's the dilemma. Contrasted by Judge Hand's belief that substance should, in appropriate instances, overcome form, is his seemingly contradictory — but wholehearted — approval of tax avoidance. Again:

Over and over again courts have said that there is nothing sinister in so arranging one's affairs as to keep taxes as low as possible. Everybody does so, rich or poor; and all do right, for nobody owes any public duty to pay more than the law demands: taxes are enforced exactions, not voluntary contributions. To demand more in the name of morals is mere cant.

### **Hand Dropped the Ball**

I'm reminded of the guidance provided by that noted philosopher Yogi Berra: "When you reach the fork in the road, take it." Alas, the substance over form doctrine largely is incapable of informing meaningful judicial decisionmaking.

Consideration of the substance of the transaction, without considering the middle (the statute and the form) on which the transaction rests, diminishes the doctrine to a slogan that in many cases is an excuse for fuzzy thinking. It results, often, in setting aside forms that the law has long acknowledged to exist.

The alternative, however, is equally problematic. A court's assertion of a statutory purpose or its uncovering of a statute's higher nature (for example, the requirement of a business purpose or economic substance) usually is a matter of aesthetics — a determination that "encapsulates one's own tastes, either generally or regarding the transaction under scrutiny."

After all:

- Some transactions in the tax code are tax preferred. Taxpayers take advantage

of those opportunities. By what measure are some transactions too "sterile" or "woodenly literal" to give effect? Should motive count? Judge Hand did not think so.

- The substance over form doctrine has not forestalled the necessity for Congress to change the law. Congress does so with great frequency.
- Courts might concern themselves less with how to save the world from manipulative taxpayers and more with giving effect to what the statute says.

The doctrine of substance over form is soft because its touchstone is infirm and its application haphazard.

The government, of course, would beg to differ. It has seized and never let go of the opportunity that this doctrinal confusion has sown. The government knows that the taxpayer generally is stuck with the form it chooses and the steps it takes in furtherance of its goal. While a taxpayer must take consistent positions, the government holds itself to no such standard. The government can argue either form or substance, as suits its purpose. It will argue that the taxpayer is stuck with its chosen form — which cannot bring about the desired result — or that the chosen form should be set aside because the result is "bad."

### **Judge Hand's Legacy**

Judge Hand's venture into tax metaphysics has been met with more acceptance than agreement and more attempted application than realized synthesis. Consider the cases that the courts decided following *Gregory*. In each, the courts, like ping-pong players whose volleys employ various strokes and spins, bat the substance over form doctrine back and forth, affirming or reversing, with no conclusion to the game.

Fast-forward 70 years. We are no further along in figuring any of this out. Economic substance doctrine notwithstanding, the government and the courts allow some forms to prevail over substance in each breath we take — even, in fact, after we stop breathing.

Take estate planning. That endeavor has risen (or fallen, depending on one's perspective) to a level that can be fairly described, I think, as make-work. A whole industry exists to plan estates — an effort that "frequently involves nothing more than the creation and execution of a variety of documents that have absolutely no actual effect on the life of the person whose estate is planned."

Or consider the international tax arbitrage industry, which plays off one nation's tax system against another's to reduce a firm's tax bills. For that strategy, companies are set up with no employees, no products, and no customers with a mailing address in the appropriate jurisdiction. Critics believe it is "a complete and utter construct to get around the rules at both ends." Supporters characterize it as "a structured capital-markets business" for the purpose of "tax efficiency." No indication exists that any of those transactions will have to be unwound.

On the other hand, other transactions that arguably result in "tax efficiency" are routinely subject to attack as vehicles for creating "artificial tax benefits." No one can figure out, or hope to apply consistently, the principles that animate those decisions. The ping-pong matches continue.

Abusive tax shelters, which the government believes are particularly bad, are but one tar pit in this swamp.

The most current refinement of the economic substance doctrine, apparently, is that tax benefits should be denied if the expectation of gain that motivated the transaction derived primarily from the tax savings, not from gain inherent in the transaction itself. What amount of "real" gain is required is anyone's guess.

So the question must be asked: If the courts cannot figure out the form-substance distinction in the context of valid tax planning, how is more expected by the rest of us?

## Legal Doctrine: A Laughing Matter

The answer is that we are using the wrong test. The test should not be whether the transaction is a violation of the economic substance doctrine. Echoing Aristotle, the test should be whether the transaction is absurd.

Sure, the absurdity test is subjective — but no more than the economic substance doctrine is "objective." In all events, I'll know it when I see it. The courts will too.

If the transaction conforms to the words of the statute, and the substance — and therefore the result — of the transaction is not absurd, the transaction should stand.

Just think — we may finally get a laugh out of applying the law. If the courts start upholding too many "bad" results, Congress can step in and do its job. Congress can write its laws to make those laws less subject to "manipulation." It can plug the dike. It can close the loophole. It can define its term. If Congress wants a business purpose or economic substance doctrine, it can legislate one.

Congress might even consider simplifying the law. Or is that too absurd to even imagine?

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