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## Tax Neutrality

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**MÉLANGES  
EN L'HONNEUR DE  
PIERRE BELTRAME**

**“TAX NEUTRALITY”**

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# “TAX NEUTRALITY”

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I met my honored friend and colleague Pierre Beltrame more than a decade ago, when my interest in technical and comparative aspects of taxation had just taken root. As many who know him will attest, he is one of the most generous of mentors, and he was at the height of his powers as a distinguished expert on French tax law. During my first short stay at Aix, we met several times. These conversations set me on the path to a deeper and more nuanced knowledge of the subject we share. I am proud of and grateful for my connection with our wonderful friend.

Is tax neutrality an illusion? My honored friend Pierre Beltrame and his distinguished co-author Lucien Mehl once wrote: “[L]orsque le taux de l’impôt s’élève, qu’il devient progressif, et que d’importantes masses monétaires sont redistribuées, le fait financier ne peut être neutre, *stricto sensu*, à l’égard, ni de l’ensemble de l’économie, ne de la répartition de revenu national” (Pierre Beltrame & Lucien Mehl, *Techniques, Politiques et Institutions Fiscales Comparées*, Presses Universitaires de France, Paris, 2d ed., 1997, p. 314). As they also observed, however, relative judgments of neutrality, judgments that purport to deal the neutrality of isolated elements of a tax system, do seem possible (*op. cit.*, pages 314-315). Tax experts generally discuss tax neutrality today as if the distinction between absolute and relative neutrality were not of great importance. For example, they regard neutrality in the taxation of enterprises – the like treatment of formally different but economically similar juridical entities – as desirable, regardless of other non-neutral elements the tax system as a whole may embrace (*op. cit.*, pages 380-386). The main purpose of this article is to explore the grounds for both these views – the impossibility of absolute neutrality and the possibility of ascertaining the relative neutrality of a tax measure.

As background, consider the following. France is today a leading supporter of the proposed common consolidated corporate tax base for Europe, whose purpose is to achieve greater capital import neutrality and export neutrality within the European Union. Seeking neutrality as well, many EU Members and the United States now impose roughly the same rate of tax on corporate dividends and other corporate distributions<sup>1</sup>. EU Members are also currently struggling to achieve non-discriminatory tax treatment of corporate distributions to shareholders whose

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<sup>1</sup> Finland, Italy, the Czech Republic, Rumania, Poland, Germany and Ireland tax dividends at between 12.5% and 20%, with 15% as the average and median rate.

residence is not that of the distributing corporation; non-discrimination is tax neutrality shaped by special concerns of the Treaty of Rome. These and similar developments in international tax policy are evidence of a widespread conviction that tax rules should not influence private economic decisions, at least when no intended non-tax purpose exists. Neutrality in this sense is of course not a new goal. Early classical economists, never reluctant to recommend tax reforms, were in broad agreement that widespread economic problems of their day sometimes resulted from unanticipated taxpayer response to tax legislation. Resurgent interest in this as a supremely important aspiration in tax design is striking.

A tax measure is neutral if it does not influence the economic choices of economic agents, chiefly, producers and consumers. Neutrality is not to be confused with fairness. A one-time tax levy, imposed without warning, would be neutral, because economic agents would not have an opportunity to alter their behavior in response to it (Carl Shoup, *Ricardo on Taxation*, Columbai University Press, Morningside Heights, New York, 1960, pages 25-40). Such a tax might be patently unfair, based on criteria such as age, height, or religious affiliation. Tax neutrality is thus concerned only with preventing the distortion of economic behavior by an extraneous influence and not with the fairness of tax consequences to those who bear them.

In this article I discuss the problems implicit in efforts to evaluate the tax neutrality of specific tax measures and then survey some high-profile recent applications of the tax neutrality standard. I then comment on the relationship between the recently promulgated rule under United States tax law according to which the usual tax consequences of a transaction are to be disregarded if that transaction lacks "economic substance." The economic substance doctrine has evolved rapidly during the last two decades as an important weapon in the government's struggle against allegedly abusive tax shelters. I therefore explore the link between that doctrine and tax neutrality as a goal of tax system design. Finally, I conclude that the economic substance doctrine weakens or abandons a useful feature of earlier case-by-case analysis of tax shelters that could and probably did help to make the United States tax system more neutral, whereas the results of the economic substance standard have no clear relationship to that goal.

#### **DISILLUSIONMENT WITH ABILITY TO PAY**

Before turning to the current prominence of tax neutrality as a standard of good tax design, it is worthwhile to notice that this standard seems to have eclipsed one of its chief and equally longstanding rivals. In the nineteenth century, John Stuart Mill's brief but convincing account of ability to pay prompted tax economists, who were quickly becoming modern welfare economists, to analyze the relationship between income tax rates and the welfare burdens resulting from an income tax. Mill had assured his readers that "equality in taxation should be the rule," because "[a]s a government ought to make no distinction of persons or classes in the strength of their claims on it, whatever sacrifices it requires from them should be made to bear as nearly as possible with the same pressure upon all, which, it must be observed, is the mode by which least sacrifice is occasioned on the whole" (J.S. Mill, *Principles of Political Economy*, John Murray, London, 1848, Book V ("On the

Influence of Government”), Chapter 2 (“On the General Principles of Taxation”). Two strong claims are contained in this single sentence. The first is that “equality in taxation” is equivalent to taxation that imposes an “equal sacrifice” on each taxpayer. “Equal sacrifice” is obviously more expansive than “equal exaction” or “equal liability”, both of which can be achieved only by a poll or capitation tax. The broader standard “equal sacrifice” obviously contemplates equality in some other respect. The second claim made in the crucial sentence suggests, without explicitly stating, what that other form of equality might be. Mill says that equal sacrifice by individual taxpayers assures that the sacrifice “on the whole”, viz., by all taxpayers collectively, will be the least necessary. Mill’s second claim is true only if he is measuring sacrifice in terms of utility and if higher income has a marginal utility that is the same for all taxpayers and diminishes in the same linear proportion for all taxpayers (Richard Musgrave, *The Theory of Public Finance*, McGraw-Hill, New York, 1959, pages 232-46).

It may have seemed intuitively obvious to Mill and his contemporaries that all people have the same utility schedule for income in money and that this schedule assigns a linearly diminishing marginal utility to higher levels of income, but Mill and his contemporaries did not think of this in mathematical terms and their conception of utility may itself have differed from that which emerged as the standard conception after the marginalist revolution in welfare economics (Stephen Utz, “Ability to Pay”, *Whittier Law Review*, Vol. 23, 2002, pages 867-950).

In any case, recent commentators are so uneasy with Mill’s case for proportional taxation of income that they distance themselves from equality arguments for or against the income tax (David Bradford, *Untangling the Income Tax*, Harvard University Press, Cambridge, Massachusetts, 1986, pages 178-197; Jøel Slemrod & Jon Bakija, *Taxing Ourselves*, MIT Press, Cambridge, Massachusetts, 1996, pages 112-115). (Mill was also an early proponent of the familiar utility-based fairness argument for consumption taxation *instead* of income taxation, and this argument assumes just as strongly that fairness must be understood by reference to a universal equal valuation of the cost of deferring consumption.) As enthusiasm has waned for ability to pay or any other utility-based standard of fairness as a basic design criterion for broad tax systems, it is not surprising that tax neutrality has attracted more and more attention.

### A FRESH PURSUIT OF TAX NEUTRALITY

Given that earlier political economists had focused primarily on tax neutrality, it was to be expected that the difficulties of ability to pay might restore tax neutrality to prominence as a topic of interest. As the twentieth century progressed, other writers saw tax neutrality as virtually the only topic worthy of economists’ attention. Nicholas Kaldor, Richard Musgrave, Carl Shoup – to mention only three public finance economists who have had a large influence on the English-speaking world – have all expounded clearly and incisively the importance of tax neutrality (Nicholas Kaldor, *An Expenditure Tax*, London, George Allen & Unwin, 1958; Richard Musgrave, *The Theory Of Public Finance*, New York, 1954; Carl Shoup, *Public Finance*, Chicago, Aldine Publishing Co., 1969). In this they clearly built on the earlier work of Arthur Pigou and Frank Ramsey, among others, in which it may

have been assumed too lightly that taxpayers have identical utility schedules for money but whose positive contributions to our understanding of tax neutrality were convincing in spite of that, because identical utility schedules might for this purpose have seemed to be merely a simplifying assumption that could eventually be relaxed, when the goal of neutrality was spelled out in more detail (Arthur Cecil Pigou, *The Economics Of Welfare*, Macmillan Publishing Co., London, 1920; Frank Plumpton Ramsey, "A Contribution to the Theory of Taxation", in *Foundations: essays in Philosophy, Logic, Mathematics and Economics* (ed. D.H. Mellor), Cambridge, Cambridge University Press, 1978).

It is worthwhile to sample the current discussion of tax neutrality by noting a few recurrent applications of that notion. The following examples are chosen for the frequency with which they are mentioned by experts as well as for the contrasting demands they place on our knowledge of economic "laws" and facts.

1. *Substitution of untaxed for taxed goods.* As economists began to analyze how markets interact, a conspicuous example was the effect of a tax on goods in one market with demand for substitutable goods in another market. For example, if a tax on tennis rackets raised their price by 1 monetary unit per racket, the demand for rackets should decline, assuming that there were potential consumers for whom the value of a tennis racket fell somewhere between the price with the new tax and the old price without the tax. These frustrated tennis players might spend their money instead on squash rackets if squash rackets were not taxed at the same rate as tennis rackets. Frank Ramsey's innovative model of this phenomenon became one of the most admired illustrations of mathematical economics in the early twentieth century (*op. cit.*, page 242). He demonstrated that it was possible to eliminate the non-neutrality of a tax on consumer goods by ensuring that the tax also increased the cost of all substitutable goods to the same extent.

2. *The labor/leisure tradeoff.* A widely recognized source of tax non-neutrality is the distortion caused when a tax on wages operates to induce potential workers to prefer leisure to labor. This elicits comment from experts in many connections. The labor/leisure tradeoff is notoriously easy to eliminate – but the cure is also universally regarded as a political impossibility. We would only have to tax leisure at the rate applicable to labor (presumably a rate per unit of time worked or enjoyed in idleness). Both income and consumption taxes fail the test of neutrality in this regard. Leisure is "consumed" without tax under both types of tax design.

3. *Tax burdens on consumption timing choices.* A parallel but more easily remedied source of non-neutrality provides one of the standard arguments for preferring a pure consumption tax to a pure income tax. The argument is that the income tax discourages deferred consumption and the consumption tax does not, because the income tax falls both on an amount saved for future consumption as well as on the earnings from that saved amount, whereas the consumption tax falls only on the deferred consumption, which can be therefore be funded with the untaxed earning of the amount saved (David Bradford, *Untangling the Income Tax*, Cambridge, Mass., Harvard University Press, 1962; Joseph Bankman & David A. Weisbach, "The Superiority of an Ideal Consumption Tax Over an Ideal Income Tax", 59 *Stanford Law Review*, 1413, 2006). An underlying premise is of course that the true value of

deferred consumption is its present value, measured from the time when the decision to delay the consumption is made. If this is conceded, it does follow that deferred consumption is taxed more harshly than current consumption. Note that the argument is not directed to the fairness of the heavier taxation of deferred consumption but to the apparent distortion of decisions whether to consume right away or to wait. Nicholas Kaldor, moreover, another consumption tax proponent has argued for precisely the opposite conclusion. Since people obviously do decide to defer consumption, despite the alleged burden of the income tax on deferred consumption, he concludes that deferred consumption always indicates the income-tax-paying consumer's disproportionately strong preference for deferral. If so, the income tax burden should be seen as less of a burden, falling only on those whose desire for deferral is marginal (Nicholas Kaldor, *An Expenditure Tax*, London, George Allen & Unwin, 1958, pages 120-134).

4. *Differentiation in the tax treatment of dividends and interest on corporate debt.* Taxes on corporate and other business profits have been scrutinized closely for suspected distortion of business investment decisions. Modigliani and Miller are famous for their analysis of the distortion built into a corporate tax regime that allows no deduction for distributions of earnings to shareholders but does allow a deduction for corporate payment of interest to creditors (F. Modigliani & M. H. Miller, "The Cost of Capital, Corporation Finance and the Theory of Investment", 48 *American Economic Review*, pages 261-297, 1958). They point out that by discriminating between debt and equity in this fashion, corporate tax regimes like that still in force in the United States – the so-called "classical" or "double" corporate tax – biases corporations towards borrowing as an alternative to seeking capital contributions in exchange for ownership shares in the corporation.

A variant on the debt/equity theme compares the tax consequences of the sale of corporate stock with the receipt of a dividend. The stock of a corporation that has undistributed earnings, earnings that might be distributed as a dividend, should in general attract a higher price than the stock of the same corporation without the earnings. In many countries, including the United States until 2004, the rate of tax applicable to the gain on the sale of stock is less than that applicable to the distribution of a dividend. The rate difference appears likely to make shareholders prefer selling their stock, especially in cases of small holdings of publicly traded stock, to receiving a dividend. Most publicly traded US corporations pay almost no dividends. In fact, the received wisdom is that changes in a corporation's invariably low dividend rate are intended more as signals to the stock market of the corporate managers' optimism or pessimism about the corporation's future performance than as a reflection of past performance.

Each of the foregoing examples of tax analysis in terms of neutrality is so familiar to most tax policy experts as to be almost platitudes of the field. It is also important to mention, in juxtaposition with these examples. When looked at from the government's perspective, favorable tax treatment claimed by a taxpayer under a given tax rule may represent a misuse of the tax system if the transaction is economically equivalent to other transactions that routinely receive less favorable tax treatment. To maintain the neutrality of the system, administrators therefore argue that economically similar transactions should receive similar treatment, and the

sought-after tax advantage should be denied. If enforcement of this standard of similar treatment were widespread and effective, disturbance of competition between at least some similarly situated taxpayers would be abated, and to this limited extent the tax system would cause less distortion to the economy. Prospectively, it would also restore economic agents' reliance on non-tax motives for their economic choices.

### CAN WE JUDGE THE NEUTRALITY OF A TAX SYSTEM?

Before describing how the goal of tax neutrality figures in current debates in the United States, it is useful to explain why *real-world* (as opposed to hypothetical or model-based) judgments about the neutrality of tax laws are simply beyond our reach<sup>2</sup>.

The radical difficulties that beset our ability to determine the tax neutrality of actual laws are both difficulties of theory and difficulties about obtaining the relevant evidence, though many commentators choose to ignore both. Consider first the evidentiary difficulties. We must bear in mind that tax neutrality is a matter of how people react to legal rules. Although we may intelligibly speculate about how ideal agents would behave in markets that are absolutely (i.e., unrealistically) isolated from other markets, as partial equilibrium models of single markets or industries illustrate, we do not know what a world without tax would be like. The most robust industrial countries have been taxed for so long that direct evidence of how their producers and consumers would behave in a tax-free world does not exist (William Popkin, "Tax Ideals in the Real world: A Comment on Professor Strnad's Approach to Tax Fairness", 62 *Indiana Law Journal* 63, 1986, pages 71-72).

Even more basic is the intractable problem of gathering the data about markets in the real world. The admirable work of Shoven, Whalley and their co-workers who attempted to "apply general equilibrium" analysis of the US economy, using data collected over a thirty-year period by the US Department of Commerce, was limited, in the view of these researchers themselves, by the unreliability and incompleteness of even this most comprehensive of available databases. It is unlikely that a better database will ever exist, even with unlimited funding, because we can only decide which data to collect based on fallible judgments of what is relevant. To decide which data are relevant, we need laws of economic causality to guide us. If we know that the values of variables  $x$  and  $y$  determine the outcome  $z$ , we must seek the actual values of  $x$  and  $y$  if we wish to predict (or explain retrospectively) the value of  $z$ . Rarely will we happen to collect the data needed for a prediction or explanation without such knowledge or at least a narrow selection of possible correlations, on one of which we expect to be able to rely, once we have done further empirical testing. Data collection is, at least in this very weak sense, dependent on pre-existing theory.

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<sup>2</sup> Without analyzing these difficulties at length, Professor Beltrame has succinctly pointed them out and bases his comparative examination of a range of specific tax institutions on the recognition that concrete judgments of tax neutrality are beyond our ability. *Op. cit.*, pp. 314-315.

Difficulties about data, however, are only the beginning. Whether a given tax rule would be neutral, on its own or when added to a broader set of tax rules, is problematic for deeper theoretical and practical reasons. First, the counterfactual proposition that but for some tax rule people would make particular decisions differently can only rest on a strong predictive theory of human behavior. An important ambiguity affecting the goal of neutrality is whether only “rational” behavioral responses to tax measures should be considered to make them non-neutral. If irrational behavioral responses must also be considered, the evaluation of tax neutrality must depend on our first knowing how human beings actually behave that would go beyond any currently available psychological research. In order to say whether a tax measure produced a change in an economic agent’s conduct we would have to know, not just whether and how this agent would react to the measure *ceteris paribus* but also how the agent would react to the measure when all other circumstances are taken into account, i.e., when the *ceteris paribus* assumption is relaxed. The required level of factual knowledge and predictive capacity obviously goes beyond anything of which we are now capable. Another theoretical weakness in our understanding of tax neutrality is that we must decide, and this is a theoretical rather than a practical decision, whether other concomitant events that are not causally dependent on the application of the tax measure to be assessed are to be considered in that assessment. For example, a tax measure that would be deter consumers from purchasing a certain kind of good, when other substitutable goods were readily available, could not do so if substitutable goods were all made unavailable by a cataclysmic accident of nature – e.g., famine might wipe out all other foods that might be substituted for taxed bananas, thereby preventing the banana tax from causing or increasing the non-neutrality of the tax system.

Second, economists differ drastically in their views about even the most basic features of a complex economy. One need only mention the division between general equilibrium theory (including “rational expectations” theory) and opposing theories (Keynesian or neo-Keynesian) that do not assume markets tend towards general equilibrium (tend to “clear” simultaneously). So far, it appears that there is nothing approaching consensus among the experts, concerning the choice between even these very broad types of theory – comparable almost to the choice between Aristotelian and Newtonian mechanics.

Without such a consensus, it is possible, though the argument would be too complex for the scope of this paper, that collecting data needed to decide narrow questions like the tax neutrality of alternative tax rules could be done in a practical way.

Third, there is no obvious measure of degrees of non-neutrality. We may have some intuitive sense that economic distortions caused by the tax law may be more or less injurious. Perhaps the obvious point of reference is the difference a given distortion makes in the social product over some long period of time. But we have no crystal ball for deciding when, how often, or even whether an economic system in the real world would ideally be in equilibrium and hence theoretically performing at its best; hence, we also cannot say what time frame is appropriate for applying this quantitative test for the detrimental effect of a given distorting influence (assuming that we could gather other relevant data for doing so). Other

measures of the severity of distortions are possible but we are so far from consensus on a common standard that we have not even noticed the need for one.

Detecting the absolute difference in tax neutrality due to the new legislation may also be possible by means of a general equilibrium model of the economy subject to the tax system. To refer again to Shoven and Whalley's attempt to "apply general equilibrium", the prospects for the establishment of an authoritative general equilibrium model that might serve as a basis for predictions about a real-world economy is less than overwhelming. Nonetheless, the general goal of modeling general equilibrium for a particular country's economy is not far-fetched. One of the difficulties this raises, of course, is whether the "laws" of economic competition do indeed favor equilibrium, as neo-classical economics holds, or disequilibrium, as Keynesian economics plausibly claims. Shoven and Whalley found it difficult, using the best data available, to identify a point in time at which the US economy was almost in equilibrium (John B. Shoven & John Whalley, *Applying General Equilibrium* [Cambridge Surveys of Economic Literature], 1992). They were nevertheless committed to framing a model that assumed the economy tended towards equilibrium.

One reason for the widespread delusion that we can know how masses of people react to the tax laws to which they are subject is the spurious analogy between economics and the physical sciences. Although scientists and philosophers of science no longer debate the topic heatedly, there is no doubt that economic hypotheses are not seriously offered for testing and are rarely regarded by economists to be vulnerable to refutation when confronted with data. The principal reason for this is that their generalizations – like any other empirical generalizations – are true at best with hosts of variables assumed to be constant or not in play. But these qualifications are never stated, nor does field of economics contain any serious empirical research project whose goal would accomplish this. John Stuart Mill argued that the proper way to understand a generalization in economic theory is as an "inexact" statement, a statement that is true only *ceteris paribus* and yet for which we are not able even broadly to identify the "other things" that must be "equal" in order to these generalizations themselves to be true (See J.S. Mill, *A System of Logic* (1843); Daniel Hausman, *The Inexact and Separate Science of Economics*, 1992, *passim* & pages 123-125).

It is true that hypotheses in physics and other "hard" sciences are also accepted or held to be well supported *ceteris paribus*. The difference is that we *do* have some idea what the circumstances are that must be assumed in order for these hypotheses to be applicable. Tests of these hypotheses sometimes refute them, and physical scientists agree that they do. It is true that the community of scientists bend over backwards at times to avoid recognizing that refutation has occurred, changing their ground about which "other things" must be assumed "equal." The view that scientific revolutions hinge on such moments of resistance has been made famous by Thomas Kuhn and must be acknowledged. It does not follow, however, that day-to-day testing of hypotheses in the phase of development that Kuhn called "normal science" is hobbled by uncertainty about confirming and disconfirming evidence (Thomas S. Kuhn, *The Structure of Scientific Revolutions*, MIT Press, Cambridge, Massachusetts, 1960).

The theoretical and practical problems briefly sketched in the last two paragraphs should be obvious, when we compare the project of assessing tax neutrality with predictive and explanatory projects of the sciences. Although physics can predict much about relatively isolated macro-physical objects, applying the best confirmed physical laws to the description of such everyday phenomena as the flipping of a coin or the movement of balls on a billiard table is sufficiently problematic that we regard these phenomena as governed by chance. One reason for this difficulty is closely associated with a quite general problem afflicting causal analysis of all sorts. In order fully to appreciate the unsatisfactory character of economic analysis in causal terms, it is useful to consider this broader problem briefly.

It has often been noted that “cause” is used variously in theoretical as well as in everyday contexts. One need only mention Aristotle’s four senses of the term – material, formal, efficient, and final – to illustrate the variety. Although modern theorists since the age of Hume and Kant have discounted the philosophical significance of all but efficient causes, their goal has been the theoretical one of calling attention to the type of cause that seems most central to causal explanation in the sciences. Yet further analysis along these lines has stressed the paradoxical and incomplete character of our understanding of efficient causality, otherwise the most reputable member of its family. The problem is essentially that all the features of efficient causality that reflect our everyday understanding of the notion, taken together, still do not permit us to distinguish causes in this sense from concomitant events that we would not consider to be causes. The main features are four. First, a cause is supposed to have an invariable relationship with its effect – the effect always occurs when the cause *does*. Modern consciousness of logical relationships has prompted philosophers to gloss this feature more formally: a cause is a necessary and sufficient condition of its effect. No sooner had this proposal been formulated, however, than it was noted that not all causes are necessary conditions of their effects – some *can* produce the effect but are only one of several causes that do so – and causal imputations are virtually never complete enough to state sufficient conditions for any effect that may be under scrutiny. For example, we may say that my pressing a button causes my desk lamp to turn on, but this tacitly assumes a host (arguably, an infinite number) of conditions without which the lamp would not turn on (electricity being supplied to the house, the wiring of the lamp being in good condition and properly designed for its purpose, the nonoccurrence of other conditions that might cause the lamp too short out, etc.). Second, a physical cause is commonly expected to be an event that is spatially near its effect, but this feature is very often lacking, most notably, from causal explanations that are especially broad and have greater than usual explanatory power, such as causal physical explanations that rely on “action at a distance.” Spatial proximity of course is rarely a possible feature of economic causality. A drop in price, for example, may be thought to cause increased sales, even though the price adjustment is not the kind of event that can be spatially near any other event. Third, temporal proximity characterizes certain physical causes, as when a baseball ball strikes a ball and sends it flying – and this *does* seem to be one of the features we sometimes but not always associate with alleged historical and economic causes. Gibbon’s claim that the rise of Christianity caused the fall of the Roman Empire hypothesized slow-acting and hence temporarily remote causal agency; the same is true of economic claims about the effect of

market freedom on desirable but far-flung economic outcomes. Finally, the relationship of cause to effect is supposed to be asymmetrical. It is the cause that causes the effect, rather than the reverse. But apart from supposed physical causes that satisfy conditions of spatial and temporal contiguity, it is difficult to see how many causal explanations, especially of results involving human choices, can be seen as possessing this characteristic.

Most importantly, the notion of a cause is unnecessary for mathematical sciences such as physics, in which regularities involving allegedly related phenomena, usually quantitative features of these, are studied without the need for elevating one phenomenon above the rest as an efficient cause. The same is true for the type of theoretical explanation with which economic and other models of human behavior are concerned. A large literature deals with differences between the physical and the social sciences. In this respect, however, it is important to note that their goals and methods coincide in principle.

All the more reason to regard the viability of judgments about tax neutrality as problematic. Even if we possessed a sufficiently developed economic model of the markets and other institutions that might be affected by the introduction of a tax measure, whether broad and comprehensive or incremental, it would be hard to give clear meaning to any conclusion about the causal role of such a tax measure in changing the behavior of the economic agents participating in the economic system in question.

The tax policy literature in the US includes a noticeably polemical strain of economic argument on the basis of tax neutrality for such tax law reforms as corporate tax integration (removal by one means or another of one layer of our “double” corporate tax), replacement of the income tax with a consumption tax, and most recently, “mark-to-market” accounting for business debt (allegedly following European accounting standards). I describe these sub-literatures as polemical because their recommendations are more fulsome than their arguments warrant and that they represent the pros and cons of the issues selectively, generally, ignoring criticism or weaknesses in the positions advocated. Notable among the weaknesses in their positions that go unacknowledged is their blithe reliance on *ceteris paribus* conditions – in effect, they ignore offsets and other consequences of tax law changes that affect the tax neutrality of their proposals.

#### **AN EXAMPLE OF PUBLIC POLICY BASED ON TAX NEUTRALITY**

A good illustration of this misuse of the tax neutrality standard is found in the campaign by George W. Bush’s administration, spearheaded by Columbia economics professor Glenn Hubbard while serving as chairman of the President’s council of economic advisors. Hubbard proposed that corporate dividends should be not be taxed as income to the shareholders who received them; his proposal included no other adjustment of the corporate tax rules. He argued that this would make the US tax system more neutral in its effect on economic choices, relying on the enormous literature that advocates corporate tax integration (removal of the potentially duplicative tax on corporate income that results under our corporate tax rules because

corporations are not allowed to deduct dividends and dividend recipients are not given credit for taxes previously paid by a distributing corporation).

Hubbard, however, also argued that the elimination of the deduction tax would stimulate the economy, though it was pointed out that his own previous scholarly writing had argued that tax-free dividends would not be stimulative. Given such clear evidence that his public pronouncements were in part those of a zealous advocate for the Bush administration's views, it is best to overlook this inconsistency. Instead,

Assuming that the classical corporate tax is distortive, it is far from obvious that the problem can be solved by eliminating the tax on dividends. Dividends, for one thing, are paid at the discretion of a corporation, and the US investing public is used to not receiving dividends, even when a corporation's profits are substantial. Corporations on the whole do not pay dividends, and most US corporations pay very small dividends at best and some pay none at all. Moreover, not to tax dividends at all should be regarded as non-neutral if profits from the sale of stock are still taxed, even at our preferential capital gains rate, because stock sale proceeds may and usually do represent accumulated earnings, which are potential dividends.

In the US virtually all corporations whose dividends are taxable are widely held and publicly traded. Smaller business enterprises that are incorporated usually qualify for the "subchapter S" election that results in immediate taxation of corporate earnings to shareholders and nontaxation of subsequent distributions by the corporation to the shareholders of the already taxed earnings. Other businesses are either directly held, so that their income is taxed to their owners just as wage or other income would be taxed, with the result that there is no chance of duplicative taxation of profits, or they are partnerships or limited liability companies, which are similarly immune to duplicative taxation of earnings, though with some greater flexibility in the rules governing the sharing of earnings among partners or owners.

#### **RELATIVE VS. ABSOLUTE JUDGMENTS OF TAX NEUTRALITY**

Before considering this problem in more detail, however, it is worthwhile to survey, if incompletely, the types of questions that may be asked about the neutrality of a tax rule. Are there any settings, any limited contexts in which we can realistically try to evaluate the neutrality of tax measures?

Given the theoretical and factual difficulty of applying the tax neutrality standard, some commentators, including Professor Beltrame, have acknowledged that only relative neutrality can be evaluated (Pierre Beltrame & Lucien Mehl, *Techniques, Politiques et Institutions Fiscales Comparées*, Presses Universitaires de France, Paris, 1997, 2d edition, pages 314-315). Relative neutrality, however, can be understood in (at least) two ways. When we speak of the effect of a new law on the tax neutrality of the entire tax system, we may intend to refer only to the *difference* this incremental change makes to overall tax neutrality (the *differential approach*). We may, on the other hand, understand the relative neutrality of a tax measure to be the expected response of taxpayers and others to this change, regardless of how their

behavior may offset or aggravate existing non-neutral features of the pre-change tax system (the *piecemeal approach*).

On the first approach, the effect of incremental change on overall neutrality thus depends not only on whether the change by itself would be tax neutral but also on whether its addition to the system will temper or aggravate the effect of other non-neutral features of the system. For example, if the status quo is already non-neutral because a tax on a given product induces consumers to buy something else as a substitute, a tax measure that equalizes the tax on the two substitutable products will eliminate the previous non-neutral feature, although the new measure considered by itself is non-neutral. On this approach, however, short and long-term consequences must also be identified, and the net effect of these consequences must be evaluated. There is no self-evident standard for determining the net effect of short and long-term effects. In fact, any such standard would appear to imply political choices about the temporal horizon with which policy should be concerned.

For example, a change in the rate at which corporate distributions are taxable to recipients may prompt a sudden but short-term increase in such distributions, stimulating the economy by making capital available to a wider range of investments than would have been the case if the distributed earnings had instead remained in the hands of the distributing corporations. This stimulus would be an instance of tax non-neutrality, if considered in isolation from other events. It might, when considered together with other events, correct a previous distortion that had resulted in a lower level of economic activity.

The *piecemeal* approach, however, which focuses only on the effect of a tax measure by itself on the neutrality of a tax system, *assumes* the system otherwise to have been neutral. This could coincide with the *differential* approach, if short-term effects of a tax measure outweighed other pre-existing non-neutral features *and* the correct standard for netting short and long-term effects were to give much greater weight to the short-term effects.

In fact, we often do encounter judgments about the relative neutrality of a tax rule that could be intended as based on either the differential or the piecemeal approach. One common type of neutrality judgment deals with the announcement effects of overt tax differentiation among types of transactions or income, e.g., higher tax rates for the income of incorporated enterprises than for the income of unincorporated enterprises. When first announced, such differentiation may cause investment to be diverted from corporations to the low-tax sector, a result that is non-neutral at least in the short term. It is crucial to know whether a critic of the non-neutrality in question means to say that the tax system as a whole is made non-neutral by the different tax rates (the differential approach) or only that it *would* be made non-neutral if the system were neutral to begin with (the piecemeal approach). The importance of the difference in this example is borne out by a well known work in the literature of tax design, *viz.*, Arnold Harberger's analysis showing that the long-term effect will be a higher rate on investment profits overall, and not just a

higher rate for corporate profits<sup>3</sup>. Political concern for short-term effects may (rationally?) override whatever confidence we may have in long-term equilibrium effects. If so, we may find it difficult to classify the approach to tax neutrality implicitly used as differential or piecemeal. The result of the failure to distinguish the differential from the piecemeal approach, however, gives rise at least to ambiguity or worse.

Judgments of tax neutrality that seem correct both from a piecemeal approach and from the differential approach may seem more secure for that reason. But they only straddle the two perspectives and are no more authoritative as such than the results of either approach are separately.

The piecemeal approach is in fact by far the more commonly used in discussions of tax neutrality of actual tax systems. Although judgments of tax neutrality in these discussions may allude to judgments of the overall neutrality of a tax system, e.g., to the alleged superiority of consumption taxation to income taxation, arguments from the context in which the inexact nature of economic hypotheses is irrelevant, namely, the ideal context in which all hypotheses are true absolutely and not merely *ceteris paribus*, cannot safely be imported into the more difficult context of hypotheses whose limitations are “inexact”, i.e., impossible to specify.

Detecting the absolute difference in tax neutrality due to the new legislation may also be possible by means of a general equilibrium model of the economy subject to the tax system. The success of efforts to “apply general equilibrium”, as John Shoven and John Whalley describe this project in the title of their 1993 book on the subject, is less than overwhelming. Nonetheless, the general goal of modeling general equilibrium for a particular country’s economy is not far-fetched. One of the difficulties this raises, of course, is whether the “laws” of economic competition do indeed favor equilibrium, as neo-classical economics holds, or disequilibrium, as Keynesian economics plausibly claims. Shoven and Whalley found it difficult, using the best data available, to identify a point in time at which the US economy was almost in equilibrium. They were nevertheless committed to framing a model that assumed the economy tended towards equilibrium (John B. Shoven & John Whalley, *Applying General Equilibrium*, Cambridge, Cambridge University Press, 1992 [Cambridge Surveys of Economic Literature]).

If a strong measure of tax neutrality is not available, the relative measure may be of some value. In particular, it is possible that earlier non-neutral tax measures, to which a new piece of tax legislation is being added, have “lost” their non-neutral effect because economic agents’ adjustment of their behavior to the initially non-neutral measures make those measures basic features of the environment in terms of which the markets of the economy in question are defined.

Even if existing non-neutral tax measures have not structurally changed the economy, by becoming part of the background against which the economy is

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<sup>3</sup> The analysis of corporate tax incidence traces the impact of different tax rates on corporate profits from those on profits of unincorporated enterprises (Arnold HARBERGER, “The Incidence of the Corporate Income Tax”, 70 *J. Pol. Econ.* 215, 1962).

defined, it is possible that these non-neutral tax measures are desirable for non-economic reasons. If, for example, non-neutral tax measures protected human rights (or supported some other goal that is not compatible with perfect competition of free markets), the relative effect of a new tax measure on the non-neutrality of the existing measures would be of interest, because the new measure might exacerbate or improve the admittedly non-neutrality of the existing measures, because any positive improvement in the neutrality of the combined old and new measures would be desirable.

Limited applications of the tax neutrality standard are not as demanding in principle as the absolute version discussed at the outset, but ordinary mortals are still unlikely to be able to assemble sufficient data to determine whether and to what extent an isolated real-world tax measure would affect the tax neutrality of existing tax laws.

Yet there seems to be widespread consensus that we may speak, with some semblance of empirical content, about the tax neutrality of broad features of a tax system, or subsets of rules within a larger tax system. Perhaps the most prominent example of the former is the argument for the superiority of a consumption tax to an income tax based on the different costs these two kinds of tax in their purest forms would impose on deferred consumption (Karen Burke, "Lipstick, Light Beer, and Back-Loaded Savings Accounts", *Virginia Tax Review*, Vol. 25, 2006, pages 1101, 1147). Experts also sometimes examine the neutrality of corporate or partnership tax rules, restricting themselves to a consideration of consequences that might influence the consciously made economic decisions of corporations and partnerships in their primary profit-oriented activities.

#### NEUTRALITY-BASED TAX POLICY IN U.S. TAX CASE LAW

Decisions of U.S. courts have recognized the goal of relative tax neutrality under another name. The U.S. Supreme Court first articulated its "substance over form" standard for re-characterizing transactions (*Gregory v. Helvering*, 293 U.S. 465 (1935)). The Court held that the tax motivation of a transaction should not determine how it is taxed, but that economically similar transactions, those with similar "substance," should be taxed alike, no matter what their formal differences; hence, "substance over form" is controlling. The "substance" to which the Court referred is invariably understood as the economic consequences of the transaction. (I will refrain from referring to the "substance over form" standard as an "economic substance" standard, however, because the latter phrase has come to mean something notably different, as will be discussed below.) The particular problem before the Court in *Gregory* was whether a multi-step transaction should be re-characterized as a simple distribution by a corporation to its sole shareholder. The corporation had contributed property to a newly formed subsidiary and then distributed the stock of the subsidiary to the parent's sole shareholder, who caused the subsidiary to be liquidated. The three transactions had the same effect as a simple distribution of the property to the shareholder. The Court held that the substance of the transaction was a simple distribution to the shareholder and disregarded the multi-step form actually used, with the result that the distribution was a taxable dividend to the shareholder rather than a liquidating distribution on which no tax

would have been due. In a practical setting, as the Court itself obviously thought, it is possible to see through formal differences to the underlying economic reality of a transaction. When we exercise this type of x-ray vision, we are saying that in selected cases formally dissimilar transactions should be given the same tax treatment in order to prevent tax consequences from influencing the decisions of the relevant agents (corporate managers or directors in this context).

Examples of reclassification based on “substance over form” nevertheless leave tax scholars puzzled. The ostensible goal is always to identify transactions that are somehow mischaracterized, usually by the taxpayer. The focus of the analysis, however, depends crucially on selection of “the transaction” to be analyzed (TSN Liquidating Corp. v. U.S., 624 F.2d 1328 (5th Cir. 1980)). A corporation engaged in an ongoing business can hardly be expected to make economic decisions in isolation from one another. Each of a corporation’s transactional decisions should be examined for its possible influence on others. In the context of analyzing a particular transaction, we may feel strongly that we can limit our attention to a small field of related transactions and decisions. The restrictive perspective adopted in such instances, however, can only be justified by inarticulate intuition – it looks or feels right to ignore other transactional decisions as irrelevant, and we cannot say more.

Viewed sympathetically, however, the judicial inquiry into the “substance” of a transaction has stronger empirical credentials than neutrality analyses based on broad economic modeling assumptions. When a court applies the substance-over-form doctrine in a particular case, the question is a practical one: do economically equivalent transactions occur at all, and if so, what is their common form? The search for the common form is relevant, because the tax system should not accord different tax consequences to transactions that would be indistinguishable in a world without tax. Although we have no world without tax against which to make such a judgment, we do have some evidence of what that world would be like – the conduct of actual economic agents in our tax-laden world.

What form does this evidence take? Courts have often treated the question whether a given formal structure is consistent with the substance of a transaction as interchangeable with the question whether there is a credible business reason for framing the transaction in this way – the so-called “business purpose” test. So common has this test become that the IRS has made it a specific regulatory requirement for certain tax outcomes<sup>4</sup>. The relationship between the business-purpose test and substance-over-form characterization of transactions depends on the de-centralized decision-making of actual taxpayers, the economic agents who engage in the similar transactions used as a benchmark in judicial determinations of this kind. If the parties involved in a transaction have a substantial non-tax economic motive for engaging in it, they would presumably engage in it in a no-tax world and the transaction can be given the tax treatment corresponding under normal tax rules with the form of the transaction, because this application of the tax rules *to all transactions of the same kind* will not induce economic agents to alter their behavior. In principle, a choice that is over-determined – that would have been made in the absence of the

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<sup>4</sup> For example, a statutory merger of one corporation into another is eligible for nonrecognition treatment only if the merger has a business purpose. Gregory v. Helvering; Treas. Reg. § 1.368-1.

tax rules but that would have been made exclusively for tax reasons with the current tax rules in place – raises no concern as to the neutrality of the tax system.

There are of course limits to the reliability of this or any kind of counterfactual reasoning (David Lewis, *Counterfactuals*, Harvard University Press, Cambridge, Mass., 1973). A credible business reason for a transaction may still be a pretext, or it may be insufficient to rebut the allegation that the transaction in this context for this taxpayer is that rare exception to the otherwise prevailing pattern of similar transactions that are not fundamental tax-motivated (Joseph Bankman, “The Economic Substance Doctrine”, 74 *S. Cal. L. Rev.* 5, 2000, pages 23-26 (asking how much expected profit is enough to give a transaction a business purpose). The “weight” of factors influencing a decision is after all a metaphor; we have no scale for measuring degrees of influence of reasons.

A principle on which the tax laws of many jurisdictions rely (France, Germany, the US) is that the influence of tax considerations on a decision should not be taken into account in deciding whether the transaction should be re-characterized in order to preserve tax neutrality. But motivation is subtly relevant in a different respect. If tax neutrality is the goal of preserving the decisions of economic agents from the influence of tax incentives and disincentives, the existence of motives that overwhelm any possible influence of these incentives and disincentives – motives related only to the profitability or other non-tax outcomes of the transaction – supports the conclusion that a transaction has not been influenced by the tax law. Thus, the question whether to re-characterize a particular transaction often reduces to the simpler question whether the transaction had a sufficient business purpose apart from tax considerations, even if tax considerations did in fact influence the decision as well.

#### **THE “ECONOMIC SUBSTANCE” DOCTRINE IN THE COURTS AND IN LEGISLATION**

Substance over form is just one of several "common law" doctrines in U.S. tax law. For example, courts have refused to recognize transactions that are sham as well as those that have no business purpose or economic substance. Since these doctrines are judge-made, a particular court's interpretation of one or more of them may leave uncertainty about their relationship to each other and even about their distinctness. In recent litigation the economic-substance doctrine has begun to be the most frequently applied of these doctrines. One reason for this is an apparently deliberate government litigation strategy, which emphasizes economic substance because of its flexibility and perhaps because non-expert judges can more readily understand it than the other narrower doctrines that it resembles. Congress has recently passed legislation that codified the economic-substance standard, thus approving the government's position; after the IRS chief counsel objected, the codifying language was removed from the last tax legislation<sup>5</sup>. The reason for the Chief

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<sup>5</sup> Chuck O'TOOLE, “Senate Overrides Farm Bill Veto; Tax Package Enacted”, 2008 *Tax Notes Today* 101-1 (May 23, 2008) (deletion of “economic substance” codification from already passed legislation in order to override presidential veto); Jeremiah CODER, “Korb Again Condemns Idea of Codifying

Counsel's opposition was that the codified version of the doctrine would make it more difficult to invoke in litigation, where the government has recently used the doctrine very successfully in its more flexible, common-law form<sup>6</sup>.

The doctrine contains a subjective element that departs from the long established principle that a tax-avoidance motive justify the denial to a taxpayer of a tax advantage linked to a given transaction, at least if there is a business purpose for the transaction. According to the emerging "economic substance" doctrine, whether the taxpayer's transactions should be respected for tax purposes turns on both the "objective economic substance of the transactions" and the "subjective business motivation" behind them. These aspects of the inquiry do not form part of a "rigid two-step analysis," but instead are recognized as "related" factors that must be considered and may perhaps be given different weight in different cases. The facts of a case may apparently make one factor more important than the other; the facts of the case can perhaps make one factor override the other.

The bipartite formulation of the economic substance analysis may mean no more than that a taxpayer who enters into a transaction for reasons other than favorable tax consequences does not engage in the kind of tax-induced behavior that neutrality is meant to prevent. The important feature of the transaction would not be that the taxpayer had an innocent purpose or acted in good faith, and is therefore deserving of the sought-after favorable tax consequences. The intent of the taxpayer need not be the focus of the subjective prong of the doctrine.

On the other hand, the subjective factor can easily be (mis)interpreted as the requirement that the taxpayer should not have been trying to improve his or her tax position. So interpreted, this prong would put the economic-substance doctrine at odds with the frequently recognized principle that "there is nothing sinister in so arranging one's affairs as to keep taxes as low as possible" (Commissioner v. Newman, 159 F.2d 848, 850-51 (2d Cir. 1947) (dissenting opinion of Hand, J.)).

In fact, the judicial teaching is anything but clear on this point. Courts that have addressed the question have all affirmed that the objective element (closely resembling the business-purpose test) and the new subjective element are closely related (ACM P'ship v. Comm'r, 157 F.3d 231, 247 (3d Cir. 1998); Saba P'ship v. Comm'r, 78 T.C.M. (CCH) 684, 713-15 (1999); UPS of Am., Inc. v. Comm'r, 78 T.C.M. (CCH) 262, 270 (1999)). Only one recent decision, however, has confirmed the traditional view that a transaction for which there was a business purpose ("objective economic substance") must be respected for tax purposes, regardless of the taxpayer's motivation (157 F.3d at 248). The courts are divided as to whether a transaction for which a positive subjective reason is found therefore passes muster, even though it lacks objective justification (Saba, 78 T.C.M. (CCH) at 713-15 (*comparing* Horn v. Comm'r, 968 F.2d 1229, 1237 (D.C. Cir. 1992), *with* Kirchman v. Comm'r, 862 F.2d 1486, 1492 (11th Cir. 1989)). In practical terms, then, the tests are interrelated in those cases in which evidence as to objective intent is

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Economic Substance", 2007 *Tax Notes Today* 209-6 (October 29, 2007) (IRS Chief Counsel opposes codification).

<sup>6</sup> Jeremiah CODER, *op. cit.*

inconclusive. In such cases, strong but not dispositive evidence of objective substance can offset weak evidence of subjective substance, and vice versa.

Economic substance has become a predominant judicial standard for judging tax abuse in the course of the government's long campaign against a new breed of tax shelters. Many of these tax shelters have common features – e.g., allocation of gain to a party that is exempt from tax in the U.S. and a related loss to a U.S. taxpayer, or early recognition of a loss by a taxpayer who transfers responsibility for some later contingent liability to a separate entity in exchange for a current payment of the anticipated value of the loss. Even more conspicuous, however, are the complexity of the transactions, evidently intended to disguise from the tax auditors what is going on, and the extreme disproportion between the taxpayer's investment in the activity and the tax write-offs claimed<sup>7</sup>. The transactions thus are elaborately contrived, so that once they come to light, virtually all tax experts regard them as abusive. Nevertheless, the deliberateness of the taxpayers' quest for tax advantages is precisely the characteristic that previous case law had held irrelevant in determining validity.

In practical terms, the difference between economic substance with its two elements and earlier neutrality-supporting common-law doctrines is that the subjective element of economic substance permits the government to introduce evidence of the contrived or strained nature of a transaction, as indirect evidence of the taxpayer's alleged abusive intention in using a disputed transaction form. For example, the government may show that the taxpayer's professional advisers have used the same tax-advantaged structure for a number of clients, each of which has made a minimal investment in a cookie-cutter transaction with the prospect of disproportionate tax savings (*Long Term Capital Holdings, LLC v. U.S.*, 330 F.Supp.2d 122, 127 (D. Conn. 2004) (same taxpayer entered into two virtually identical tax-saving transactions with the help of the same team of tax advisers)). While such evidence does not establish that the transaction is abusive, it does suggest that both the clients and the professional advisers regarded it simply as a way to deprive the government of tax revenue. Yet under previous tax doctrine, the tax avoidance motive by itself would not have supported re-characterization of the transaction. Similarly, the government may produce evidence that a tax adviser was approached after the taxpayer already knew that it was likely to receive a sizeable taxable gain (*See, e.g., Stobie Creek Investments LLC v. U.S.*, No. 05-748T, 07-520T, \_\_Fed.Cl. \_\_, 2008 WL 2968170 (July 31, 2008)). The timing alone suggests a tax avoidance motivation, but again, that motivation should not have been considered relevant under earlier versions of the common-law doctrines that were the government's only weapons against tax abuse in the past.

On the whole, the government's use of economic substance has been closely allied with a broad litigation strategy aimed at remarkably deliberate and overreaching tax shelters. It is tempting to say, as many tax experts do in private, that these shelters are so glaringly abusive that close scrutiny and clear analysis are not

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<sup>7</sup> Jeremiah CODER, "Tax Shelter Penalties are Unclear and Weakly Enforced, Panelists Say", *Tax Notes*, 383, 384-85 (August 4, 2008)(summarizing the comments of Dennis Dohoune, chief senior litigation counsel of the Justice Department Tax Division).

called for. It is probably true as well that few federal appellate judges have the specialized knowledge necessary to understand the genuine merits of transactions involved in the shelters. The government's litigation strategy is therefore dictated in part by the need to simplify the legal standard and allow the judges to rely on their intuitive assessment of the taxpayers' conduct, inevitably focusing on the taxpayers' motivation rather than on an objective application of tax principles, including that of neutrality. Unfortunately, this leaves the law in the precariously ad hoc and ad hominem state.

Not all is lost, of course. The government is unlikely to argue that perfectly ordinary and modest examples of tax-sensitive business planning lack economic substance and are therefore invalid. On the other hand, tax professionals will find it even more difficult than previously to give a reasoned defense of the validity of these perfectly ordinary and modest tax positions. It could be said that, despite the problems raised by the concept of relative tax neutrality, the older common-law standards of substance over form and business purpose had at least some foundation in traditional tax policy, whereas the new standard, though expedient, is obscure.

### CONCLUSION

As my friend Pierre Beltrame correctly pointed out, tax neutrality is unattainable in the strict sense and yet relative tax neutrality is often a reasonable and empirically ascertainable goal. I have argued that this is especially so when we are concerned primarily with the announcement effects of new tax measures and when our goal is to decide whether the tax treatment a taxpayer seeks is "neutral" in comparison with the treatment of other economically equivalent transactions. Recent developments in U.S. tax law suggest that the economic substance doctrine has something other than tax neutrality as its goal, when it gives the subjective motivation of the taxpayer a different significance than it had in the earlier common-law doctrine of substance over form.

8/26/08

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