The Duke and the Lady: Helvering v. Gregory and the History of Tax Avoidance Adjudication

Assaf Likhovski *

*Tel Aviv University, likhovsk@post.tau.ac.il

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Tax avoidance is one of the major problems that every tax system faces. Courts play an important role in fighting tax avoidance, but the scope of judicial intervention in tax avoidance schemes varies. Certain courts and judges adopt a more passive and formalist attitude to tax avoidance while other courts pursue a more active, substantive approach. What factors influence judicial attitudes to tax avoidance? The article seeks to answer this question by examining the history of one specific landmark case, Helvering v. Gregory, decided by Judge Learned Hand in 1934.

The article examines the legal, cultural and political factors that influenced Hand’s decision. It argues that one major factor that led Judge Hand to decide the way he did was the immediate political context in which the case was decided: In the months and weeks prior to the decision, tax avoidance by the rich had become a major political issue and public opinion was captivated by scandalous revelations about the tax avoidance schemes of a group of leading industrialists and bankers, chief among whom was Andrew Mellon, former Secretary of the Treasury. Using the story of Gregory as a case-study, the article shows that only a comprehensive historical approach which takes account of internal doctrinal developments as well as the influence of culture and politics can explain the history of tax avoidance adjudication.
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The article examines the legal, cultural and political factors that influenced Hand’s decision. It argues that one major factor that led Judge Hand to decide the way he did was the immediate political context in which the case was decided: In the months and weeks prior to the decision, tax avoidance by the rich had become a major political issue and public opinion was captivated by scandalous revelations about the tax avoidance schemes of a group of leading industrialists and bankers, chief among whom was Andrew Mellon, former Secretary of the Treasury. Using the story of *Gregory* as a case-study, the article shows that only a comprehensive historical approach which takes account of internal doctrinal developments as well as the influence of culture and politics can explain the history of tax avoidance adjudication.

* Senior Lecturer, Tel Aviv University School of Law. Golieb Fellow in Legal History, New York University School of Law 2002/3. Email: likhovsk@post.tau.ac.il. For comments on previous drafts I am grateful to Joseph Bankman, Yariv Brauner, David Duff, Orly Erez-Likhovski, Victor Fleischer, Marjorie Kornhauser, Pnina Lahav, Gerry Leonard, Michael Livingston, Judith Resnik, Tanina Rostain, David Schizer, Dan Schneider, Ted Sims, Ann Thomas, Dennis Ventry and the participants of the American Bar Foundation Research Seminar, Boston University Legal History Series, the Critical Tax Conference held at the University of Michigan School of Law, New York University School of Law Legal History Colloquium and the Stanford/Yale Junior Faculty Forum. The Cegla Center at Tel Aviv University provided financial support for my research.
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INTRODUCTION

What factors influence the way judges decide tax cases? More specifically, what factors shape judicially-created anti-avoidance doctrines? This is the question that this article seeks to answer.

Tax avoidance is a “tax perennial”, an issue that is constantly on the top of the agenda of tax policy experts and lawmakers. Tax avoidance is also one of the few areas of tax law which captures the attention of the general public because it involves highly

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1 Tax law makes a distinction between “tax evasion,” “tax avoidance” and “tax minimization”. Evasion is defined as a “clear violation of the tax laws such as fabricating false accounts.” It is a criminal offense. Avoidance is defined as a “behavior by the taxpayer that is aimed at reducing tax liability, but that does not constitute a criminal offense.” The term is usually applied to a reduction or elimination of taxes which is done in contravention of the intention of the legislator by abusing gaps or loopholes in the law without breaching specific statutory duties. Avoidance is not criminal but it often leads to recharacterization of the transaction by the courts. Minimization is defined as “behavior that is legally effective in reducing tax liability” which is neither criminal nor leads to recharacterization. For example, not consuming certain products such as alcohol which are subject to taxation. See TAX LAW DESIGN AND DRAFTING 44-6 (Victor Thuronyi ed., 1996). The actual boundaries between these three categories are fuzzy. One indication of this is that different people will use different terms to describe tax avoidance (for example what the taxpayer will see as legitimate “tax planning”, “tax savings”, “tax minimization”, “tax reduction” or “sheltering” may be viewed as “tax evasion” “tax abuse” or “tax dodging” by the government). Ultimately, it seems that the boundaries of the categories are not objective but vary over time and are determined by political, economic and moral considerations. An early legal-realist discussion of these categories can be found in RANDOLPH PAUL, Restatement of the Law of Tax Avoidance, in STUDIES IN FEDERAL TAXATION: TAXATION WITHOUT MISREPRESENTATION 9 (1937). Another attempt to distinguish between avoidance and evasion was suggested by Franklin D. Roosevelt who said that “tax avoidance means that you hire a $250,000-fee lawyer, and he changes the word ‘evasion’ into the word ‘avoidance’.” #The Two Hundred and Twenty Fifth Press Conference July 31, 1935 in THE PUBLIC PAPERS AND ADDRESSES OF FRANKLIN D. ROOSEVELT 313? (1935). See also Alan Gunn, Tax Avoidance, 76 Mich. L. Rev. 733 (1978); George Cooper, The Taming of the Shrewd: Identifying and Controlling Income Tax Avoidance, 85 Colum. L. Rev. 657 (1985); Theodore S. Sims, Debt, Accelerated Depreciation and the Tale of A Teakettle, 42 U.C.L.A. L. Rev. 261 (1994); Leo Katz, ILL GOTTEN GAINS 1-132 (1996); Boris I. Bittker and Lawrence Lokken, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 4.3.2 (3rd ed., 1999); Marvin A. Chirlstein, FEDERAL INCOME TAXATION § 13.02 (9th ed. 2002); Deborah H. Schenk, Symposium on Corporate Tax Shelters, part I: Foreword, 55 Tax L. Rev. 125, 127-8 (2002); James E. Eustice, Abusive Corporate Tax Shelters: Old ‘Brine’ in New Bottles, 55 Tax L. Rev. 135, 153-60 (2002); Michael L. Schler, Ten More Truths about Tax Shelters: The Problem, Possible Solutions and a Reply to Professor Weisbach, 55 Tax L. Rev. 325, 328-32 (2002) (examples of the many attempts to define tax avoidance).

2 Joseph Isenberg, Musings on Form and Substance in Taxation, 49 U. Chi. L. Rev. 859, 863 (1982).
contested political and moral issues. How should the State and fellow citizens view a taxpayer who uses legal means to reduce her tax burden? Where should the line between legitimate use and illegitimate abuse of the tax code be drawn? How should one balance between the desire for certainty (which entails a respect for the formal legal structures chosen by the taxpayer) and the need for equity (which entails a refusal to allow schemes which unfairly reduce the tax burden of some taxpayers)? Indeed, in recent years interest in the subject has gain momentum as the government and the academia have attempted to tackle the corporate tax shelter problem.

Courts in most legal systems play a major role in fighting tax avoidance. They interpret and apply anti-avoidance provisions found in the tax code and they sometimes also create judicially-made anti-avoidance doctrines of their own. Yet there is no systematic study that seeks to analyze the factors that shape judicial attitudes to tax avoidance from a historical or sociological perspective. This is not surprising. Tax law is

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generally perceived as a legislative rather than a judicial enterprise and tax scholars therefore tend to devote more attention to legislation. In addition, tax scholarship is mainly interested in descriptive and normative discussions of tax law and is preoccupied by policy considerations rather than by the need to explain developments in the law.6

An exception that proves the rule is a new collection of essays that has attempted to reconstruct the historical context of ten landmark tax cases.7 The appearance of this book may be an indication that history is slowly capturing the attention of tax scholarship which has been, for the most part, a-historical in recent decades.8 However, the

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8 See also Steven A. Bank, Mergers, Taxes and Historical Realism, 75 Tul. L. Rev. 1 (2000); Steven A. Bank, Entity Theory as Myth in the Origins of the Corporate Income Tax, 43 Wm. and Mary L. Rev. 447 (2001); Steven A. Bank, Corporate Managers, Agency Costs and the Rise of Double Taxation, 44 Wm. and Mary L. Rev. 167 (2002); Kirk J. Stark, The Unfulfilled Tax Legacy of Justice Robert H. Jackson, 54 Tax L. Rev. 171 (2001); Dennis J. Ventry Jr. “Equity versus Efficiency and the U.S. Tax System in Historical Perspective,” in TAX
The historiographical aims of this collection of essays are quite modest since it is mainly a pedagogical text. The goal of most of the essays in this collection is to describe the specific facts of the cases chosen and to discuss the significance of these cases. They do not attempt to reach more general conclusions about the nature of tax adjudication and the political and other non-legal factors that motivate it. Thus there are still no studies which try to explain rather than describe the development of the doctrines, that is to ask “why did judges view tax avoidance in a certain way at a certain time?”

One way to answer the question, “what factors shape judicial doctrines on tax avoidance?” is to reconstruct in detail the micro-history of specific landmark cases, hoping to find in the historical sources the answer to the riddle of judicial motivation. The use of history is necessary because of the nature of judicial decisions. When judges decide cases, they are motivated by ideological, economic, cultural and institutional...
factors. However, these factors are usually invisible to the reader of the decision. This is because the conventions of opinion-writing often prevent judges from mentioning them. In addition, some of these factors have an unconscious or semi-conscious influence on judges. However, sometimes one can find evidence of the influence of such factors on judges by examining documents (such as internal memos) which are inaccessible to scholars at the time in which the case is decided. In addition, by reconstructing the historical context in which a specific case was decided, one can sometimes point to the influence of non-legal factors which were not evident to contemporary observers because they lacked the necessary historical hindsight. Naturally, proving “influence” is often difficult and resort has to be made to interpretative methods which impute influence rather than “prove” it in any direct way, but such interpretative techniques are neither unusual nor novel. They have been “for a hundred years the most important characteristic of American debates about adjudication.”

The landmark case on tax avoidance which I will examine in this article is *Helvering v. Gregory*, decided by Judge Learned Hand of the United States Court of Appeals for the Second Circuit in March 1934 and later affirmed by the Supreme Court. I chose to discuss Hand’s opinion rather than the decision of the Supreme Court because the

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10 These conventions are, of course, a product of specific historical circumstances and they change over time. See generally, Robert Post, *The Supreme Court Opinion as Institutional Practice: Dissent, Legal Scholarship and Decisionmaking in the Taft Courts*, 85 MINN. L. REV. 1267 (1985).


12 *Helvering v. Gregory*, 69 F.2d 809 (2nd Cir. 1934).
Supreme Court adopted Hand’s position stating that “the reasoning of the court below … leaves little to be said.”\textsuperscript{13} This case is often seen as a milestone in the adoption of a substantive anti-taxpayer approach to tax avoidance in American law and is one of the most cited tax cases ever.\textsuperscript{14}

I argue that a major factor that led Hand to decide the way he did was the political context in which the case was decided. Because of his general political convictions, Hand was predisposed to an anti-taxpayer position on tax avoidance and this pre-disposition was augmented by the fact that tax avoidance by the wealthy had become a subject of intense political debate at the precise time that Helvering v. Gregory was decided. In the months and weeks prior to the decision, newspapers were filled with reports about the tax avoidance tricks practiced by a group of leading industrialists and bankers, chief among whom was Andrew Mellon, former Secretary of the Treasury.

Saying that current political events and newspaper reports influence the way judges decide cases may be viewed as another version of the extreme rule-skeptic approach,


wrongly associated with some legal realists. Since this position seems nihilistic, legal scholars have rarely taken the trouble to account for such influences and this is certainly the case in the scholarly literature on tax avoidance, which prefers to analyze tax decision using abstract normative arguments or economic-analysis-of-law models rather than examining the concrete and immediate context in which real-world tax decisions are made. This article does not advocate the wholesale adoption of an extreme rule-skeptic approach. Like some recent histories of early 20th century adjudication, it is based on a belief in the importance of internal doctrinal changes and in the partial autonomy of law. Indeed, it will show that one of the factors that led to Hand’s decision in Gregory was a gradual internal shift that was occurring in doctrines on tax interpretation and tax avoidance at the time that the case was decided. But it also argues that internal legal changes alone cannot account for the decision and that only a complex, multi-causal,
“thick” approach, which takes account of the immediate historical context, can enable us to understand *Gregory*.

The article proceeds in the following way: Part I summarizes *Gregory* and compares it to a similar British landmark case decided by the House of Lords a year later, *The Duke of Westminster*. It uses the British case to introduce a political explanation of tax avoidance adjudication which will later serve as one of the templates for the examination of *Gregory*. Part II is a survey of a number of other theoretical approaches to the development of tax avoidance doctrines and tax law generally. Part III contains a discussion of the legal context in which *Gregory* was decided. It begins with a history of the development of canons of tax interpretation and anti-avoidance doctrines in the late 19th and early 20th centuries. It then argues that an explanation of *Gregory* which is solely based on internal legal factors is inadequate. Part IV discusses two non-legal factors that may have influenced the way Judge Hand decided the case. First, cultural and moral discussions of tax avoidance. Second, the immediate economic and political context. This part tells the story of the tax implications of the Depression – tax revolts, the use of the “soak the rich” rhetoric as a political tool by the FDR administration and the story of some of the tax trials of the rich and famous in the early 1930s, including the story of the “tax trial of the century”17 - the indictment of Republican patrician and former Secretary of the

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17 *See* Stark, *supra* note **, at 189-96 (a brief history of the criminal tax evasion indictment and civil tax avoidance trial of Andrew Mellon).
Treasury, Andrew Mellon, for tax evasion which occurred while Gregory was being decided.

The article concludes with a discussion of the relevance of the Gregory story to wider socio-legal, comparative and jurisprudential discussions of tax adjudication. It also suggests that this story has some relevance to the contemporary corporate tax shelter debate. The aim of the article is to understand Gregory but it also seeks to use the specific case as an opportunity to demonstrate that only a complex, multi-layered, contextual approach can help us gain a real understanding of the way judges create tax doctrines.

I. THE LADY AND THE DUKE

I. The Lady

Mrs. Evelyn F. Gregory was a wealthy lady from Brooklyn. She was the sole owner of the United Mortgage Corporation, a company which held some shares of another company, Monitor Securities Corporation. In 1928, when the Monitor shares had a market value of $133,333, Mrs. Gregory decided to sell them. One way to do so was for

18 Mrs. Gregory was the wife of George D. Gregory, private secretary of multi-millionaire banker and philanthropist V. Everit Macy. At the time of his death in 1931, George D. Gregory left an estate worth about $400,000 (more than $4 million in 2002 dollars). See Attack Bangs Will for Gifts to Public, N. Y. TIMES, Dec. 10, 1931; Estates Appraised, N. Y. TIMES, Sept. 29, 1932 (information on the life of George D. Gregory and his estate); V. Everit Macy Left $775,000 to Charity, N. Y. TIMES, April 3, 1930 (brief description of Macy’s life and fortune); Brief for the Respondent, Helvering v. Gregory, U.S. Court of Appeals, Second Circuit, Case no 13158 (filed 20 February 1934), p. 3, National Archives-Northeast region, New York, NY (containing information on the United Mortgage Company).
United to sell the Monitor shares and distribute the after-tax profit to Mrs. Gregory. In this case to the after-tax profit of the sale received by Mrs. Gregory would have been considered a dividend and would have been taxed again as ordinary income. Another method would have been to have the Monitor shares distributed to Mrs. Gregory as a dividend and then sold by her. In this case too the Monitor shares transferred to Mrs. Gregory would have been taxed as ordinary income.

In order to sell the Monitor shares while paying only a capital gains tax (at a rate lower than the rate on ordinary income) while simultaneously reducing the amount taxed, Mrs. Gregory created a new corporation, Averill. The sole purpose of Averill was to reduce Mrs. Gregory’s taxes. United transferred the Monitor shares to Averill and Mrs. Gregory received all of Averill’s shares. This, Mrs. Gregory claimed, was a tax-free reorganization under the provisions of section 112(g) of the Revenue Act of 1928.

The summary of the facts of the case is based on the briefs for the petitioner and respondent in the case. See Helvering v. Gregory, U.S. Court of Appeals, Second Circuit, Case no 13158, National Archives-Northeast region, New York, NY.

In this case, United would have paid $14,760 in corporate income tax and Mrs. Gregory would have paid an income tax of at least $15,000. See Helvering v. Gregory, U.S. Court of Appeals, Second Circuit, Case no 13158, National Archives-Northeast region, New York, NY, brief for the respondent, at 4.

The tax paid by Mrs. Gregory in this case would have been about $20,000. See Helvering v. Gregory, U.S. Court of Appeals, Second Circuit, Case no 13158, National Archives-Northeast region, New York, NY, brief for the respondent, at 4. A third way to transfer the Monitor shares to Mrs. Gregory without paying an ordinary income tax would have been to liquidate United.

Revenue Act of 1928 § 112 (g) stated that “if there is distributed, in pursuance of a plan of reorganization to a shareholder in a corporation a party to the reorganization, stock or securities in such corporation or in another corporation a party to the reorganization, without the surrender by such shareholder of stock or securities in such a corporation, no gain to the distributee from the receipt of such stock or securities shall be recognized.” Revenue Act of 1928 § 112 (i) (1) (B) defined “reorganization” as “a transfer by a corporation of all or a part of its assets to another corporation if immediately after the
Three days later Averill was liquidated. Mrs. Gregory received the Monitor shares as the sole asset of Averill and she immediately sold them. Mrs. Gregory contended that she had received the Monitor shares from Averill as a single liquidating dividend taxed as a capital gain. She also asserted that the capital gain was only $76,000 - the market value of the Monitor shares less their cost to her.\(^{23}\)

The Commissioner argued that Averill should be disregarded and that the receipt of Monitor shares by Mrs. Gregory should be treated as if United sold the Monitor shares and distributed the proceeds as a dividend to Mrs. Gregory. The Board of Tax Appeals accepted Mrs. Gregory’s position based on a literal approach to the interpretation of the term “reorganization” in the Revenue Act of 1928.\(^{24}\)

Judge Learned Hand, who wrote the Second Circuit opinion in this case, reversed the decision of the Board of Tax Appeals.\(^{25}\) The case contains contradictory messages. On one hand, Hand asserted that “a transaction … does not lose its immunity, because it is actuated by a desire to avoid, or, if one choose, to evade, taxation. Any one may so transfer the transferor or its stockholders or both are in control of the corporation to which the assets are transferred.” See generally Bank, Mergers, supra note ** (a history of the reorganization provisions).

\(^{23}\) Mrs. Gregory paid $350,000 to purchase United. In 1928 all the assets of United (including the Monitor shares) were valued at $814,064. The basis for determining the gain from the receipt of the Monitor shares was therefore 133,333/814,064 X 350,000= 57,235. Mrs. Gregory thus reported a capital gain of only 133,333-57,325=$76,008. The tax on this amount was $9,500. See Helvering v. Gregory, U.S. Court of Appeals, Second Circuit, Case no 13158, National Archives-Northeast region, New York, NY, brief for the respondent, at 3, 5.

\(^{24}\) Gregory v. Commissioner, 27 B. T. A. 223 (1932).
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.”26

On the other hand, Hand argued that the transfer of the Monitor shares to Averill was not a real “reorganization” using a purpose-based approach to tax interpretation.27 Thus, despite the fact that Mrs. Gregory’s transaction fell literally within the meaning of the term “reorganization” as it was defined in the Revenue Act of 1928, that provision would not apply since just “as a melody is more than the notes” so the “meaning of a sentence may be more than that of the separate words.”28 The purpose of the reorganization provision, Hand added, was to exempt reorganizations undertaken for “reasons germane to the conduct” of a business and not when the sole purpose of a

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25 Hand did not fully follow the Commissioner’s approach. He did not disregard Averill as the Commissioner suggested. Instead, he argued that the issue of Averill shares to Mrs. Gregory should be seen as a dividend to her.

26 Helvering v. Gregory, 69 F. 2d 809, 810 (2nd Cir. 1934). See also Asiatic Petroleum Co. (Delaware) Limited v. Commissioner, 79 F. 2d 234 (1935) (Swan J. citing Gregory in support of the proposition that taxpayers can legitimately decrease their taxes); Commissioner v. Eldridge, 79 F. 2d 629 (1935) (citing Gregory in support of the proposition that a taxpayer may resort to any legal method available to him to diminish the amount of his tax liability’’); Rands v. Commissioner, 34 B.T.A. 1094 (1936) (citing Gregory for the proposition that the purpose to save income taxes is now legally above reproach’’). See generally, Shaviro, “The Story of Knetsch,” supra note **, at 323 (discussing the “dual nature” of Hand’s utterances and their subsequent impact on case-law). See also Chirelstein, supra note ** at 445-46, 452 (noting that Hand’s willingness to abandon literalism in Gregory was limited rather than revolutionary and that he himself understood his decision in a conservative way); KATHRYN GRIFFITH, JUDGE LEARNED HAND AND THE ROLE OF THE FEDERAL JUDICIARY 26-30 (1973) (discussing Hand’s later attempts to narrow the Gregory doctrine).

27 Helvering v. Gregory, 69 F. 2d 809, 810 (2nd Cir. 1934).

28 Id.
transaction was tax avoidance. Hand’s approach was adopted by the Supreme Court a year later.\textsuperscript{29}

Gregory is one of the most cited tax opinions of all times. It is also a problematic and ambiguous case. Hand did not explain why he thought that courts should adopt a purposive approach to tax interpretation instead of assuming, as the Board of Tax Appeals in this case did, that “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.”\textsuperscript{30} Hand also failed to explore the implications of his approach. In his decision, Hand examined the legislative history of the reorganization provisions of the Revenue Act of 1928 and concluded that the purpose of the reorganization provisions was to exempt “the gain from exchanges made in connection with a reorganization in order that ordinary business transactions will not be prevented.”\textsuperscript{31} But the use of the term “ordinary” begs the question whether, given the realities of business life, transactions undertaken in order to minimize taxes are should not be deemed “ordinary.” However, the general consensus has been to view the case as a major milestone in the adoption of a

\textsuperscript{29} Gregory v. Helvering, 293 U.S. 465 (1935).

\textsuperscript{30} Gregory v. Commissioner, 27 B. T. A. 223, 226 (1932). The Board of Tax Appeals approach to tax interpretation echoed words which Hand himself uttered less than a year before deciding Gregory. See Delaware & Hudson Co. v. Commissioner 65 F. 2d 292 (June 5, 1933) in which Hand argued that “a taxing system so detailed and particular as ours does not admit of the same flexibility of interpretation as one in more general terms. Perhaps its very refinement may defeat its purpose; elaboration often does. But the more articulate the expression, the less room remains for intendment beyond the words used”.

\textsuperscript{31} Helvering v. Gregory, 69 F.2d 809, 811 (2nd Cir. 1934).
substantive approach to tax avoidance. As such, it has become a landmark tax case, one which is mentioned in many basic casebooks on tax law, and which has gained legal immortality in the citation practices of courts.

II. The Duke

The Supreme Court of the United States affirmed Hand’s decision in *Gregory* in January 1935. Four months later, in May 1935, a similar problem faced the British House of Lords in the *Duke of Westminster* Case. The outcome, however, was quite different. While *Gregory* has become a cornerstone of the American substantive, purpose-based, anti-taxpayer approach to tax avoidance, the *Duke* has been the cornerstone of a narrow, literal, pro-taxpayer approach which had dominated British and Commonwealth tax-avoidance law until the 1960s.

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32 See, e.g., Paul, *Restatement*, supra note ** at 120-26, 141 (describing it as one of the “leading modern tax avoidance cases”); ROBERT S. HOLZMAN, *SOUND BUSINESS PURPOSE* 6-7 (1958) (discussing the impact of the case); Chirelstein, *Learned Hand’s Contribution*, supra note **, at 440, 441 (1968) (discussing the case as “a major event in the history of tax administration in this country” which is “still among the most significant and best remembered judicial statements on the subject” and noting that this case established Hand’s “preeminence” as a tax judge). One writer even referred to cases decided prior to it as “pre-Gregorian.” See J. S. Seidman, *The Gregory Reorganization Case*, 13 TAX MAG. 130 (1935).


35 On the impact of the case see Brian J. Arnold, *General Description: Canada*, in *COMPARATIVE INCOME TAXATION*, supra note **, at 35-36; DUFF, *supra* note **, at ** (discussing the impact of the case on Canadian law). On its meaning see Tiley, *supra* note ** at 93-94 (distinguishing between two possible understandings of the *Duke of Westminster* doctrine, one which simply states that the legal facts created by the parties should be respected and another, less-refined understanding which “tended to look kindly on attempts to avoid taxes”); Saunders, *supra* note ** at note 40 (arguing that to view the decision in that case as requiring that courts prefer form to substance is a “gross oversimplification”).
The Duke of Westminster, one of the wealthiest men in Britain, wanted to deduct the wages and salaries he was paying to his servants from his income in order to reduce his surtax liability. Such deductions were not allowed under British tax law but the law did allow taxpayers to deduct annuities and other annual payments they made. The Duke therefore reached an agreement with his servants that instead of paying them a salary he would pay them an annuity for a period of seven years, supposedly unrelated to the services that they were providing. He then claimed that these payments could be deducted from his income for the purpose of calculating his surtax liability. The Revenue argued that “the Court may ignore the legal position and regard what is called ‘the substance of the matter,’” but the House of Lords rejected this argument. Such a substantive approach, warned Lord Tomlin, using the rather suggestive language of Sir Edward Coke, would “involve substituting ‘the incertain and crooked cord of discretion’ for the ‘golden and straight metwand of the law’” adding that “every man is entitled, if he can, to order his affairs so as that the tax attaching under the appropriate Acts is less than it otherwise would be.”

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36 Id., at 19. Other Lords followed suit. Lord Russell added that “the subject is not taxable by inference or by analogy but only by the plain words of a statute applicable to the facts and circumstances of his case … if the Crown, seeking to recover the tax, cannot bring the subject within the letter of the law, the subject is free, however apparently within the spirit of the law the case might otherwise appear to be.” Id., at 24-5.
III. Robert Stevens and the Politics of Tax Avoidance Adjudication

How can one explain the decision in *Duke of Westminster*? There are relatively few British or American non-normative discussions of tax avoidance doctrines and certainly very few historical discussions. One rare exception to the general lack of interest in the history of anti-avoidance doctrines is a study of British canons of tax interpretation and anti-avoidance doctrines that is part of a broader analysis of the decisions of the British House of Lords written some twenty years ago by legal historian Robert Stevens. Stevens’ argument is that two major factors influenced the decisions of the House of Lords on issues of tax avoidance: class interest and the demands of social solidarity in times of emergency.

According to Stevens’ historical narrative, in the 19th century, the British courts did not treat tax matters differently from other legal matters. In the first decade of the 20th century, however, the British government introduced progressive income taxation. Following this change, a formalist, pro-taxpayer stance on tax interpretation and tax avoidance came to dominate the decisions of the House of Lords. This stance enabled the wealthy to avoid taxation, and it can be attributed to the fact that the Law Lords sought to serve the interests and to protect the wealth of “the established sections of

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society.” The burden of taxation on the wealthy increased in the 1930s, when a Labour government raised tax rates. The Duke of Westminster was thus, according to Stevens, simply a manifestation of the ideological leanings of the House of Lords.

During the second World War, the House of Lords modified its approach. Now, some Lords adopted a “patriotic” approach to tax avoidance according to which all citizens are “under an obligation to pay a fair share” of their taxes. However, once the war ended, the Law Lords returned to their old formalist, pro-taxpayer stance. Only in the beginning of the 1960s was the formalist approach to tax avoidance rejected and a new, substantive, purpose-based approach to tax interpretation adopted. This trend intensified in the 1980s.

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39 Stevens, supra note **, at 206-8;

40 Id., at 347, 392-3. See also Wheatcroft, supra note **, at 218. Another interesting example of the link between patriotic discourse and anti-avoidance norms is found in the history of German anti-avoidance law in the early decades of the 20th century. German law had been concerned with anti-avoidance since the early 20th century and various provisions dealing with the issue were enacted by the German legislator. However, the rise of the Nazi party to power in 1933 further increased the scope of substantive intervention by the courts in tax avoidance schemes, based on the reasoning that various tax avoidance methods ought to be disregarded even without specific statutory authority if they are “in violation of the public duty of loyalty imposed on every member of the community” in the Nazi State. See Paul Marcuse, Six Years of National-Socialist Practice in Taxation, 13 TUL. L. REV. 534, 553-559 (1938-39).

41 Stevens, supra note **, at 394. See also J. P. HANNAN & A. FARNSWORTH, THE PRINCIPLES OF INCOME TAXATION, 549-54 (1952).

42 See Stevens, supra note **, at 411-12; 599, 600-3; Williams, supra note **, at 420-22; Popkin, supra note **, at 291-92; J. John Tiley, Judicial Anti-Avoidance Doctrines, [1987] BRITISH TAX REVIEW, 220, 234, 244;
Despite the fact that more than twenty years have passed since the publication of Stevens’ book, and despite the rather crude instrumentalist conception of adjudication upon which it is based, his argument that formalism and substance in tax avoidance doctrines are effected by the political ideologies of the judges has not yet been challenged. Nor has anyone attempted to apply his insights to the history of American tax avoidance doctrines.

There are now some critical studies that discuss the way American tax doctrines are shaped by class-interests but none of these works deals with the history of tax avoidance doctrines. This may be a reflection of the general state of American tax scholarship, which according to Michael Livingston, often assimilates the insights of other fields of legal scholarship only after a time lag. Thus, at a time when in most legal fields class-based interpretations of legal development have become commonplace and indeed the target of historical revisionism, tax scholarship has barely begun to address the impact of class and politics on judicially-made tax law.

Can we use Stevens’ class-based model in order to understand the Gregory case? American scholars have often identified formalism with a free-market (and in our case,
pro-taxpayer) approach and substantive conceptions of legal interpretation with a pro-regulation (and in our case, anti-taxpayer) approach. It would therefore not be far-fetched to assume that the movement from formalism to substance in American tax avoidance law, in which Gregory is an important milestone, can be explained by reference to the political convictions of Learned Hand.

Of course, one could argue that there is no point in taking observations made about English tax law and applying them to the history of American tax law because of immense difference between the two societies, their political institutions and their tax systems.47 One can also argue, following legal scholars Patrick Atiyah and Robert Summers, that the formalism of English tax avoidance law in the middle decades of the 20th century and the substantive approach of American tax law during the same period were rooted in more general attributes of both legal systems.48

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46 The political and economic implications of legal formalism (a term which it is notoriously difficult to define) has been a concern of legal theory for more than a hundred years. See Duncan Kennedy, Legal Formalism 13 ENCYCLOPEDIA OF THE SOCIAL & BEHAVIORAL SCIENCES 8634 (2001) (a general survey of the various meanings of the term formalism and its political uses). See also ROBERT S. SUMMERS, INSTRUMENTALISM AND AMERICAN LEGAL THEORY (1982); ANTHONY T. KRONMAN, MAX WEBER (1983); Thomas C. Grey, Langdell’s Orthodoxy, 45 U. PITTS. L. REV. 1 (1983); William S. Blatt, The History of Statutory Interpretation: A Study of Form and Substance, 6 CARDOZO L. REV. 799, 807 (1985); Joshua Getzler, Law, Sociology and Economic History: Rethinking Intellectual Traditions in Late 19th and Early 20th Century Europe, CURRENT LEGAL ISSUES (forthcoming) (discussing various aspects of formalism and its political implications).

47 See generally SVEN STEINMO, TAXATION AND DEMOCRACY (1993) (a comparative study of the effect of different political and institutional arrangements on various tax systems).

48 See P. S. ATIYAH & ROBERT S. SUMMERS, FORM AND SUBSTANCE IN ANGLO-AMERICAN LAW 1 (1987) (for the general argument that “the American and English legal systems, for all their superficial similarities, differ profoundly: the English legal system is highly ‘formal’ and the American highly ‘substantive’”) Atiyah and Summers attributed the difference to a number of historical and institutional
This article, however, does not seek to compare English and American tax law. It takes Stevens’ arguments as a starting point of an exploration which is ultimately meant to provide a complex, multi-factored approach of the history of anti-avoidance adjudication. Before embarking on a discussion of the specific history of *Gregory* and the factors that shaped it, however, it might be useful to examine a number of other theoretical models which have been used to explain the development of tax avoidance doctrines. In the next part of this article, I will discuss three such approaches: economic analysis of law, empirical social-science studies and histories of tax legislation.

II. OTHER POSSIBLE THEORETICAL APPROACHES TO THE HISTORY OF TAX AVOIDANCE

There are countless doctrinal works that discuss legislative and judicial attitudes to tax avoidance. In many of these works there is a general exasperation with the contradictions in the cases, which prevent any possibility of finding an underlying rationale and preclude any possible logical systemization. As early as 1937, Randolph Paul, perhaps the leading tax scholar of his time, lamented the impossibility of systemizing the field. In the last decade, scholarly attention has shifted from trying to reconcile the cases, to examining the issue of tax avoidance doctrines from non-legal factors. They do mention the “elitism” of English judges and lawyers and their class-background, *id.*, at 38-9, 353-54, 363, but class-affiliation as such is not a major explanatory factor in their comparative discussion.

perspectives. This part of the article is a survey of some of the theoretical perspectives that have been used. It also argues that none of these perspectives can provide a satisfactory, comprehensive explanation of Gregory.

I. Economic Analysis of Law

In the last decade, an economic-analysis-of-law approach to tax avoidance has emerged. Often the economic-analysis discussion of the subject is part of a more general attempt to understand, from an efficiency point-of-view, the well-known theoretical distinction between legal rules and legal standards. One example of such an approach can be found in a 1992 article by Louis Kaplow. In this article, Kaplow argued that a major difference between rules and standards is that the initial cost of making rules is higher because rules require the lawmaker to determine the law's content in advance. However the ex post cost of standards is higher, because their exact scope is more costly to predict or enforce. Therefore when the frequency with which a certain legal norm is

50 See Paul, Restatement, supra note **, at ***.
52 For general discussions of the rule/standard dichotomy See, e.g., Duncan Kennedy, Form and Substance in Private Law Adjudication, 89 HARV. L. REV. 1685 (1976); Blatt, supra note **; Atiyah & Summers, supra note **.
applied is high, it would be more efficient to frame it as a rule. This, argued Kaplow, is the case of tax law, which applies to millions of individuals and billions of transactions.53

Unlike most tax norms, however, anti-avoidance doctrines are meant to prevent abuse of the tax code. This means that they would often have to be designed as standards, because rigid rules are easier to circumvent.54 An additional consideration favoring the use of standards to deal tax avoidance is that tax avoidance doctrines are meant to regulate behavior which varies greatly (since tax avoiders often can choose among a large number of legal ways to circumvent a particular tax norm). Determining the appropriate content of an anti-avoidance rule which would cover all contingencies ex ante is expensive and some of the expense is wasted since it will not occur in practice. This is another reason why standards would be preferable to rules as a way to deal with tax avoidance.55

Kaplow’s points were later elaborated by David Weisbach in an article which examined the implications of the rules/standards dichotomy to the design and use of anti-avoidance doctrines. In this article Weisbach has argued that in tax law, rules must be systematically more complex than standards because they need to take uncommon


54 Id., at 618 (Kaplow discusses norms meant to prevent fraud in general and then mentions tax norms dealing with sham transactions and norms meant to prevent the “circumvention of … the legislatures' intent” which is exactly what anti-avoidance norms are supposed to do).

55 Id., at 564, 622.
transactions into account (unlike rules in other legal fields). If tax rules did not take these uncommon transactions into account, these tax-exempt transactions would become common. Since there are many possible uncommon transactions, the complexity of rules, and consequently the cost of promulgating them, may be extremely high and therefore the use of standards is desirable. The end result should be a system that is based on rules (which are more efficient *ex post*) but also governed by overriding anti-abuse standards which provide the “fuzziness” needed to prevent tax abuse – i.e. a mixture of rules designed for common transactions accompanied by anti-avoidance standards to be used for unusual transactions. 56

Most of this literature views anti-avoidance standards from a static, normative perspective. 57 The question in which it is interested is what is the most efficient way to deal with tax avoidance. This, of course, is a legitimate question. However, it does not address the question of what actually happens in real-world courts. In addition, even from a law-and-economics perspective, such an analysis can be augmented. Law-and-economics scholarship has recently become more aware of the need to introduce the dynamics of time (and history) into its models, often in the guise of path dependency or

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evolutionary notions. Such dynamic models are also applicable to the specific issue of tax interpretation and the related issue of tax-avoidance doctrines.

One pertinent example of such a model, which attempts to explain the cycles of statutory interpretation, was suggested recently by Adrian Vermeule. Tax avoidance cases are often framed as tax interpretation problems. This was also the way that the legal question was framed in Gregory, where the tax avoidance issue was understood as a problem of choosing between a literal and a purposive interpretation of the relevant statutory provision. Therefore, discussions of interpretation are highly relevant to discussions of tax avoidance. Scholars have long noted that the history of canons of statutory interpretation seems to be characterized by a cyclical trend, oscillating between “strict” (or “literal”) and “purposive” (or “equitable”) approaches. Studies concerned

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60 See, e.g., Bankman, supra note **, at 11-12. This of course does not mean that the question is wholly a question of statutory interpretation. While the issue of the treatment of tax avoidance by the courts is tied to questions of statutory interpretation, the more general policy question of how a given tax system should view tax avoidance is not related to issues of interpretation. See Weisbach, Ten Truths, supra note **, at 217-8. See also TAX LAW DESIGN AND DRAFTING, supra note **, at 44, 46.

61 A related question is whether general discussions of interpretation are relevant to issues of tax interpretation. See Bittker & Lokken, supra note **, at ¶ 4.2.1 (“since all statutes are sisters under the skin the courts employ the usual tools of statutory construction to interpret the Code”). See also Michael Livingston, Congress, the Courts, and the Code: Legislative History and the Interpretation of Tax Statutes, 69 TEX. L. REV 819 (1991); Michael Livingston, Practical Reason, “Purposivism” and the Interpretation of Tax Statutes, 51 TAX L. REV. 677 (1996) (asking whether tax statutes are unique and consequently whether tax interpretation is different from other kinds of statutory interpretation).

with the specific nature of tax interpretation have also mentioned this trend. Yet most studies that discuss this pattern do not attempt to explain the mechanism which leads to this oscillation. In an article that attempts to explain the history of statutory interpretation (although not tax interpretation), Vermeule has suggested that these cyclical changes may be explained by an “endogenous model based on shifts in the expectations of actors in the interpretive system.” He explained the way this suggested mechanism works by using the classic “no vehicles in the park statute” example. He argued that “litigants whose activity falls within a new statute's text but not within some reasonable conception of its purpose—the person who quietly rides a bicycle through the park and is fined … will contest more cases than litigants whose activity is condemnable on both textual and purposive grounds. The judges will observe a sample of cases in which the text appears dramatically over-inclusive … and will shift towards standard-based interpretation involving venerable techniques of attributed legislative intent … over time, however, the picture will change. With increased frequency litigants will test the limits of interpretive flexibility, contesting cases in which the text clearly covers their activity and only a very narrow or grudging conception of purpose will support an exemption.” For example, a reveals a cyclical alternation between doctrinal rules that promise objectivity and certainty and equitable rules that promise justice and flexibility”).

63 Livingston, Congress, supra note **, at 823 (noting that "the current debate over statutory interpretation is the latest installment in a longstanding controversy, one with a pronounced cyclical character"); Livingston, Practical Reason, supra note ** at 680 (1996) (noting the cyclical nature of statutory interpretation theory). But see James W. Colliton, Standards, Rules and the Decline of the Courts in the Law of Taxation 99 DICK. L. REV. 236 (1995) (a non-cyclical unidirectional, internal history of the movement from standards to rules in tax law, based on the assumption that the typical process in tax law is enactment, confusion, litigation and enactment of ever more complex rule-like amendments).
person who rides a motor-powered bicycle through the park and claims that the purpose of statute was only to prevent life-endangering trucks from crossing the park. “The costs of over-inclusion produced by rule-based interpretation will diminish--or so it appears from the sample of litigated cases--and at the margin judges will increasingly favor textual interpretation. In this way judges will oscillate between rule-like and standard-like interpretations.”

In his article, Vermeule attacked the previous attempts to explain the cyclical shifts in canons of statutory interpretation because these attempts sought to explain the shifts by using “ad-hoc” exogenous factors (such as changes in ideological perceptions of the role of government in society or changes in the political affiliation of the judiciary). He argued that his endogenous model, which explains changes in the attitudes to statutory interpretation without reference to external factors, is preferable because of its simplicity, parsimony and comprehensiveness.

Vermeule’s model can certainly be applied to the history of tax avoidance doctrines and be used as one way of explaining trends in the case law. However, the argument that only endogenous factors should be taken into account is unconvincing. Historians seldom attribute real-life events to a single cause. This is also the case with legal history. In reality many factors - institutional, cultural, economic and political - determine the specific

64 Vermeule, supra note **, at 149.
65 Id., at 178-181
trajectory of a given legal system’s attitude to interpretation (and thus indirectly also to tax avoidance). Another problem with Vermeule’s model is that it lacks predictive power. It does not give an answer to the question what is the length of each cycle and when will the shift between literal and purposive approaches occur.\textsuperscript{67} The desire to simplify thus leads the economic-analysis literature to poverty in explanatory power. It either tells us, as Kaplow and Weisbach do, that from a normative point of view, anti-avoidance doctrines are desirable (ignoring the dynamic nature of real-world anti-avoidance law), or it explains, as Vermeule does, real-world shifts between rules and standards using a model which ignores the complexity of real life and has little predictive power.

One of the aims of this article will be to demonstrate that this literature can be complemented by other perspectives. Specifically, the article will seek to convince the reader that shifts in the cases cannot be explained solely by reference to cyclical models such as the one proposed by Vermeule, and that the exogenous, non-legal context, whether cultural, economic or political, was also part of the story of changes in anti-avoidance doctrines. Vermeule’s model, which ignores politics as a factor in shaping the approach of courts to statutory interpretation cannot account for such shifts. If one wishes to gain a better understanding of real-life law, the speculative models must be

\textsuperscript{66} Id., at 178.

\textsuperscript{67} Id., at 184 (admitting that “Cycling mechanisms can explain these fluctuations but cannot predict their occurrence, given that the period of the cycles is unknown and perhaps unknowable.”)
enhanced by other types of studies. One way to overcome this problem is by turning to empirical social-science-like quantitative studies. I will now discuss such studies.

II. Empirical Studies of Contemporary Decisions

Legal scholars have made relatively little use of empirical methods. 68 This is also true of tax scholarship, 69 although there have been notable exceptions such as the detailed impressive quantitative study of the tax decisions of Justice William O. Douglas published in the 1970s. 70 In the last few years however, new studies that do use empirical social-science methods in order to understand the way judges decide tax cases have appeared. Two such studies have been undertaken by Daniel Schneider, who sought to examine the

68 For discussions of early attempts to move legal scholarship in a more social-scientific empirical direction, see, e.g., John Henry Schlegel, American Legal Realism and Empirical Social Science (1995) (discussing the empirical work of some legal realists); Chris Tomlins, Framing the Field of Law's Disciplinary Encounters: A Historical Narrative, 34 L. & Soc. Rev. 911 (2000) (discussing the history of the competition between law and the social sciences). The term empirical is used here in a narrow sense, which refers to quantitative or statistical analysis. For different definitions of the term see Lee Epstein & Gary King, The Rules of Inference, 69 U. Chi. L. Rev. 1 (2002).

69 See generally Livingston, Reinventing, supra note **, at 365 (discussing, among other things, the need for more empirical research in tax law); Daniel M. Schneider, Empirical Research on Judicial Reasoning: Statutory Interpretation in Federal Tax Cases, 31 New Mexico L. Rev. 325 (2001), note 1 and 2 (listing the few articles on tax law which have made use of empirical methods).

70 See Bernard Wolfman, Jonathan L. F. Silver & Marjorie A. Silver, Dissent Without Opinion: The Behavior of Justice William O. Douglas in Federal Tax Cases (1973) (showing a shift from a pro-government to a pro-taxpayer stance in Douglas' tax decisions and attempting to explain this shift by attributing it to Douglas' dissatisfaction with administrative agencies or his antipathy to the Internal Revenue Code and the special preferences that it embodied).

Schneider has compiled a database consisting of all the decisions of the Tax Court rendered between 1979 and 1998 as well as all the published tax decisions of the federal district courts of Los Angeles, Chicago and New York City for the same period. He randomly chose about fifteen percent of these decisions (about 500 cases) as his sample and analyzed this sample using a number of variables: the judge’s gender, race/ethnicity, educational background (elite or non-elite college and law school), primary professional experience (private practice, government, teacher), political party of the president who appointed the judge, and length of service on the bench when deciding the case.\footnote{Schneider did find that an elite college education had a negative impact on Tax Court judges’ use of one of the methods (practical reasoning) but he also found that the opposite was true for federal district court judges. He found links between some social background variables (college education and prior professional experience) and the use of regulations to interpret tax statutes. However, again, these links were significant only if the Tax Court cases and the district court cases were viewed separately. \textit{See} Schneider, \textit{Empirical Research}, supra note **.}

Using statistical methods, Schneider sought to uncover relationships between social factors and the use of specific methods of statutory interpretation. He found that judges tended to favor non-literal approaches to tax interpretation, but he failed to establish any significant link between the politics, race or gender of the judges and specific modes of statutory interpretation.\footnote{Schneider did find that an elite college education had a negative impact on Tax Court judges’ use of one of the methods (practical reasoning) but he also found that the opposite was true for federal district court judges. He found links between some social background variables (college education and prior professional experience) and the use of regulations to interpret tax statutes. However, again, these links were significant only if the Tax Court cases and the district court cases were viewed separately. \textit{See} Schneider, \textit{Empirical Research}, supra note **.} Schneider also made use of his database to study the links
between pro-taxpayer decisions and the social background of the judges. Here his results were more significant. Schneider found correlations between pro-taxpayer decisions and various background factors such as the judge being a woman, being non-white, having elite education, working before appointment in private practice or being appointed by a president who was a Democrat.74

Another recent empirical study examined Tax Court opinions decided between 1993 and 1997. The study, based on an analysis of about 300 cases, found that Tax Court judges appointed by a Republican president were significantly more likely to find for the taxpayer. However, the study claims that an even more significant factor was immediate work background prior to Tax Court appointment. Republican appointees were more likely to come from private practice rather than government service and the study concludes that immediate work experience rather than ideology was the factor which really determined a pro-taxpayer bent.75

Empirical quantitative studies of tax law contribute an important perspective to understanding tax adjudication. But the use of statistics is also problematic. First, it seems that different databases lead to contradictory results. Second, such studies often assume that the relationship they are seeking to uncover is static and not dynamic. They thus ignore change over time. Third, such studies cannot account by definition for particular

74 Schneider, Assessing and Predicting, supra note **.
75 Mark P. Altieri et al. Political Affiliation of Appointing President and the Outcome of Tax Court Cases, 84 JUDICATURE 310, 313 (2001).
idiosyncrasies of specific judges. Finally, such studies examine large numbers of cases looking only at single quantifiable variables. They therefore ignore the fact that legal changes are often caused by multiple factors, some of which (like culture or contingent events) cannot be quantified. Therefore empirical studies, while extremely valuable, also need to be supplemented by more detailed studies based on a smaller sample of cases and judges and micro-studies such as the one done in this article, which take a single case and examine it in detail. This kind of inquiry necessitates the turn to history.

History can provide us with another sort of “empirical” non-normative way to study tax-avoidance decisions. The distance in time and the fact that historians can often gain access to sources that are unavailable to contemporary observers (such as judicial memos of the kind I will make use of in this article) make it possible to provide a richer, “thick” narrative which will give us a deeper understanding of the way tax law is shaped. Unfortunately, as I noted above, except for Stevens’ book, there are no studies of the history of tax avoidance doctrines. There are, however, quite a few histories of tax policy and tax legislation and the theoretical models that they use may be applicable to the history of tax adjudication as well. These histories will be discussed in the following paragraphs.

III. Histories of Taxation Legislation

Historians of taxation are concerned with the effect of social, economic and institutional factors on the development of tax policy and tax legislation. Historian W. Elliot Brownlee has identified a number of interpretative models used to explain the
history of tax legislation. Some of these models seem applicable to the history of tax adjudication too.

The first model mentioned by Brownlee is the “progressive” model, according to which the history of taxation in the United States in the 20th century can be understood as a continuous battle between pro-worker, pro-social justice advocates on one hand, and the wealthy on the other and the story is one of gradual victory of social-democratic values, epitomized by the adoption and growth of the progressive income tax.

The second approach, which Brownlee calls the “capitalist-state” or “corporatist” approach, assumes that corporations and wealthy Americans have taken over the state and shaped tax policy and tax legislation in a way that served their interests. One example of this approach is found in a work on the early history of the federal income tax written by Robert Stanley. Stanley argued that the 19th century federal income tax was meant to create the illusion of fiscal fairness by seemingly taxing the wealthy, all in order to prevent more radical redistributive measures. A variant of this approach can be found in a history of New Deal taxation written by historian Mark Leff. Leff argued that contrary to popular perceptions, New Deal tax policy did not lead to widespread income


77 Brownlee, Federal Taxation, id., at 159-60; Brownlee, Public Sector, id., at 1014-5.

78 Brownlee, Federal Taxation, id., at 163-5.

redistribution but served symbolic goals. Income tax policy in the 1930s was meant to show that the government was addressing the most glaring abuses of tax law by attacking a miniscule group of super-rich individuals (the wealthiest 1%) but it was not meant to significantly shift income from the upper and middle classes to the poor. 80 A third approach, which is actually a conservative variant of the second approach, argues that the state was indeed a captive but that it was captured by special-interest groups of “tax-eaters.” These groups used income taxation to increase the power of the state and to fund institutions and schemes favored by special-interests such as the military and social-welfare programs at the expense of ordinary Americans.81

A fourth approach, the “pluralist” model, found in John Witte’s history of income taxation views tax legislation as the confused product of the pressure of a large number of middle-class interest groups which through a long incremental process often leading in contradictory directions, shaped a complex and incoherent tax system that exempts the poor and taxes the middle class without being re-distributive.82

80 MARK H. LEFF, THE LIMITS OF SYMBOLIC REFORM: THE NEW DEAL AND TAXATION, 1933-1939 5-6 (1984). The argument that New Deal tax laws were merely a way to undermine support for more radical re-distributive proposals has already been voiced in the 1930s by historian Charles Beard. See RANDOLPH PAUL, TAXATION IN THE UNITED STATES 188 (1954).

81 BROWNLEE, FEDERAL TAXATION, supra note **, at 160-1; Brownlee, Public Sector, supra note **, at 1016-7.

The fifth and final approach, is an eclectic “democratic-institutionalist” approach, which views tax policy and legislation as shaped by the pressure of interest groups (the “democratic” element) but also assumes that the state, experts and political entrepreneurs as well as contingent events play a role. The end result is a chaotic, path-dependent trajectory where the outcome is far less certain than it is according to the other approaches.83

This variety of approaches can serve as a useful methodological arsenal for examining the history of tax-avoidance doctrines. However, it should be noted that all these approaches have been used to study the history of legislative rather than judicial attitudes to taxation. While there are quite a number of histories of federal and state tax policy and legislation (focusing on the role of Congress, the Administration or public discourse),84 very few works examine the history of the development of tax law by the courts,85 and there are no histories of anti-avoidance doctrines developed by courts. Given the fact that law is semi-autonomous, that courts are peculiar institutions and that judges

83 Brownlee, Federal Taxation, supra note **, at 172-82; Brownlee, Public Sector, supra note **, at 1016-7. On the role of the state, See generally, Theda Skocpol, Bringing the State Back In: Strategies of Analysis in Current Research, in BRINGING THE STATE BACK IN 3-37 (Peter B. Evans, Dietrich Rueschemeyr & Theda Skocpol eds. 1985). Another example of an eclectic approach to tax legislation which Brownlee does not mention is Shaviro, Beyond Public Choice, supra note **, at 31ff. (a discussion of various economic and political factors effecting tax legislation which shows how business interests variously win, lose or “benefit fortuitously without having much direct impact” on tax legislation).

84 See BRONWLEE, FEDERAL TAXATION, supra note **; Brownlee, Public Sector (surveys of some of the works).

85 But See PAUL, TAXATION IN THE UNITED STATES, supra note **, at 630-68 (discussing the history of “the judicial process in tax territory”).
are less constrained by factors that effect legislators, the various approaches to the history of tax legislation cannot be applied wholesale to the history of tax adjudication.

In summary, this part of the article has shown that the existing literature does not provide a comprehensive understanding of the way judges decide anti-avoidance cases. First, an examination of the economic analysis of law literature reveals that it is still dominated by a static, normative perspective rooted in debates about the efficiency of rules vs. standards. The only relevant dynamic, non-normative analysis which has emerged out of this literature, Vermeule’s recent article, is interesting but reductive and thus too divorced from reality to provide a complete understanding of *Gregory*. Secondly, the recent empirical attempts that quantitatively study the tax decisions of various courts is also problematic because it does not take into account change over time and because such studies deliberately confine themselves to a limited number of simple, quantifiable factors. Finally, histories of tax legislation, while they offer a number of possible explanatory approaches to the history of taxation in general, are limited to studying the history of tax policy and tax legislation. Factors that shape tax legislation may also influence tax doctrines created by the courts, yet it seems reasonable to argue that the unique discursive and institutional features of judge made law may make the history of case-law different from that of legislation and may require that tax doctrines designed by the courts be studied separately from the study of tax legislation.

In the next parts of this article, I will attempt to uncover the history of *Gregory*. In part III, I will examine the legal context of the decision, asking whether internal doctrinal
developments alone can explain why Judge Hand reached his specific decision in *Gregory*. After discussing developments in interpretation and tax avoidance doctrines in the late 19th and early 20th centuries, I will argue that legal developments cannot solely account for Hand’s decision. Part IV of the article will then examine two non-legal factors which may have influenced Hand’s position: culture and politics.

III. THE LEGAL CONTEXT

This section is an internal history of canons of tax interpretation and of anti-avoidance doctrines in the 19th and early 20th centuries. Legal doctrine is often incoherent and contradictory. This was certainly true of early 20th century tax-avoidance law which contemporary observers described as an area of “extraordinary confusion” and “chaos.”

A comprehensive quantitative study is impossible because of the huge number of cases involved, not only in federal courts but also in state courts. Therefore this section is an impressionistic description based on the study of a number of leading cases, augmented by reliance on contemporary sources which summarized trends. My goal is to determine to what extent *Gregory* was revolutionary. There can be no doubt that the case was

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86 Paul, *Restatement*, supra note **, at 74 (describing the law of tax avoidance as a “mystic field which only the initiate may enter” where “imponderables abound,” “attitudes are chaotic” and there is an “anarchy of uncertainty.”)

87 Just as an example, in the first decade after it was established (1924-1934), the Tax Court (called at the time the Board of Tax Appeals) decided more than 75,000 cases. See Dana Latham, *Taxation of Capital Gains, Tax Avoidance and Other Problems Under the Revenue Act of 1934*, 23 CAL. L. REV. 30 (1934/5). See also Vermeule, *supra* note **, at 182-3 (discussing problems involved in an empirical quantitative study of the dynamics of change in the use of canons of statutory interpretation).
perceived by contemporaries and by later generations as a major turning point. The question that this section seeks to address is whether this was indeed true or whether *Gregory* was merely the logical outcome of prior cases.

I. Tax Interpretation

Tax avoidance doctrines are intimately connected to issues of statutory interpretation and, more specifically, the debate between “literal” and “purposive” interpretation of tax law. In the common framing of the debate, “literal,” “strict” or “narrow” rules are seen

88 See, e.g., Godfrey N. Nelson, *Federal Victory in Taxation Case*, N. Y. TIMES, Jan. 13, 1935 (describing the case as an “important victory” for the government and noting that “the departure of the courts from the usual custom of basing decisions upon a literal compliance with the language of the law … is a radical change in the adjudication of tax problems [and will] … contribute uncertainty to judicial interpretations …”); Note, *Corporate Reorganization to Avoid Payment of Income Tax*, 45 YALE L.J. 134, 140 (1936) (arguing that while the decision “presents a potentially effective means of preventing tax avoidance,” it “renders certainty and predictability impossible”); Holzman, supra note **, at 3-4, 9 (noting that “although glimmerings of [the doctrine of sound business purpose] had existed for some time, the doctrine really stems from the celebrated *Gregory* case”).

89 The description does not distinguish between pre-1913 and post-1913 cases although there is no doubt that the re-introduction of the federal income tax in 1913 increased the incentive to avoid taxation. Nor does the analysis distinguish between the cases decided by the judges of the Board of Tax Appeals and cases decided by other federal judges (see e.g. Judith Resnik ‘Uncle Sam Modernizes His Justice’: Inventing the Federal District Courts of the Twentieth Century for the District of Columbia and the Nation’ 90 GEO. L. REV. 607 (2002)), between federal cases and state cases, between income tax cases and cases involving other taxes. This kind of analysis will hopefully be undertaken in the future.

90 See Bankman, supra note **, at 11-12. See also TAX LAW DESIGN AND DRAFTING, supra note **, at 44, 54. One should also note that in reality there is a gamut of approaches to statutory interpretation (and tax interpretation) and the literal/purposive dichotomy, while useful, is misleading insofar as it assumes that judges can only chose between two positions. Indeed current discussions of tax interpretation have enumerated at least five different approaches to tax interpretation: strict (literal) construction, regulations (i.e. deference to Treasury Department regulations interpreting ambiguous statutes), structure (i.e. interpretation of specific provisions in light of the general structure of the Tax Code), the use of legislative history and “practical reasoning” (i.e. a combination of literal, legislative history and policy considerations). See Schneider, *Empirical Research*, supra note ** (a summary of the five approaches and an empirical study of their actual application in the day-to-day work of four specific courts). See also Michael Livingston, *Congress*, supra note **; Deborah A. Geier, *Interpreting Tax Legislation: The Role of Purpose* 2 FLA. TAX REV. 492 (1995); John F. Coverdale, *Text as Limit: A Plea for A Decent Respect for the Tax Code*, 71 TUL. L. REV.
as pro-taxpayer and purposive interpretation is seen as favoring the government. 91 This, naturally, may not always be the case, since in the case of a tax exemption, a literal rule may be better from the government’s point of view. In addition, an approach which is pro-government in one case may turn out to have pro-taxpayer implications in another case. Still, many tax scholars tend to link the literal approach and a pro-taxpayer attitude. 92

Another way to frame the debate is to talk about the existence of a canon of interpretation according to which doubts contained in an ambiguous tax statute are to be construed in favor of the taxpayer (the contra-fiscum rule).

In the following paragraphs I present a brief outline of the history of canons of tax interpretation in the 19th and early 20th centuries. 93 Most of the 19th and early 20th century cases dealing with the issue of tax interpretation seem to have adopted a strict construction, pro-taxpayer stance. The general rule governing the construction of tax statutes can be found in such cases as Adams v. Bancroft in which it was declared that

Laws imposing duties are never construed beyond the natural import of the language; and duties are never imposed upon the citizens upon


91 See, e.g., Lawrence Zelenak, Thinking about Nonliteral Interpretation of the Internal Revenue Code, 64 N.C.L. REV. 623, 666 (1986)

92 On this link See, e.g., Smith, Business Purpose, supra note **, at 4.
doubtful interpretations; for every duty imposes a burden on the public at large, and is construed strictly, and must be made out in a clear and determinate manner from the language of the statute.94

Another early, oft-cited, case was *U.S. v. Wigglesworth*, in which it was held that

It is, as I conceive, a general rule in the interpretation of all statutes, levying taxes or duties upon subjects or citizens, not to extend their provisions, by implication, beyond the clear import of the language used, or to enlarge their operation so as to embrace matters, not specifically pointed out, although standing upon a close analogy. In every case, therefore, of doubt, such statutes are construed most strongly against the government, and in favor of the subjects or citizens, because burdens are not to be imposed, nor presumed to be imposed, beyond what the statutes expressly and clearly import. Revenue statutes are in no just sense either remedial laws or laws founded upon any permanent public policy, and, therefore, are not to be liberally construed.95

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93 The discussion of tax interpretation is intimately linked to general discussions of canons of interpretation. For a classic article, See Karl Llewellyn Remarks on the Theory of Appellate Decision and the Rules or Canons about how Statutes are to be Construed, 3 VANDERBILT L. REV. 395 (1950).

94 Adams v. Bancroft, 1 F. Cas. 84 (D. Mass. 1838).

95 United States v. Wigglesworth, 28 F. Cas. 595, 596-7 (D. Massachusetts 1842).
There are many other cases that took the same position, which was actually part of a wider trend. In the late 19th century, the purposive (or “liberal” approach) was marginalized and literal, formalist canons of interpretation were dominant. The strict construction rule also dominated the decisions of early 20th century courts. In Gould v. Gould, decided in 1917, the question was whether alimony paid by the husband to a divorced wife could be considered income for tax purposes. Justice McReynolds said that

In the interpretation of statutes levying taxes it is the established rule not to extend their provisions, by implication, beyond the clear import of the language used, or to enlarge their operations so as to embrace matters not specifically pointed out. In case of doubt they are construed most strongly against the Government, and in favor of the citizen.

See, e.g., Powers v. Barney 19 F. Cas. 1234 (S.D.N.Y. 1863) (“duties are never imposed on the citizen upon vague or doubtful interpretations”); U.S. v. Isham, 84 U.S. 496 (1864) (citing English precedents to the effect that “a tax cannot be imposed without clear and express words”); Hartranft v. Wiegmann, 121 U.S. 609 (1887) (“duties are never imposed on the citizen upon vague or doubtful interpretations.”); In the Matter of Hannah Enston, Deceased, 113 N.Y. 174 (Ct. App. N.Y. 1889) (stating that “it is a well-established rule that a citizen cannot be subjected to special burdens without the clear warrant of the law”); American Net and Twine Company v. Worthington 141 U.S. 468 (1891) (where Congress has designated an article by a specific name and imposed a duty upon it, general terms in the same act, though sufficiently broad to comprehend such an article, are not applicable to it); Rice v. U.S., 53 F. 910 (1893) (in cases of doubtful construction the court should refrain from imposing a tax or charge upon the citizen); Eidman v. Martinez, 184 U.S. 578 (1901) (laws should be liberally interpreted in favor of the importer, and that the intent of Congress to impose or increase a tax upon imports should be expressed in clear and unambiguous language); Benziger v. United States, 192 U.S. 38 (1904) (tax statutes should be liberally construed in favor of the importer, and if there were any fair doubt as to the true construction of the provision in question the courts should resolve the doubt in his favor).


The *Gould* holding later enabled other Supreme Court Justices as well as lower federal and state courts to decide in favor of the taxpayer in other cases.\(^99\) A similar narrow approach could also be found in Supreme Court decisions dealing with the constitutional aspects of tax law such as *Eisner v. Macomber*.\(^100\)

However, the formalist, strict approach favored by judges in the late 19\(^{th}\) and early 20\(^{th}\) centuries was facing growing opposition from Progressive scholars and judges. In the 1910s and 1920s academics like Roscoe Pound and Ernst Freund and judges like Louis Brandeis and Benjamin Cardozo began attacking the old conservative and formalist conception of judicial law-making and urged judges to abandon the strict construction conception of statutory interpretation in favor of more open, “equitable,” approach.\(^101\)

By the middle of the 1920s, this critique was changing the approach of some federal judges to tax interpretation. One example is *Irwin v. Gavit*, in which Justice Holmes discussed whether periodical payments that a taxpayer received from the income of an estate intended for his child, must be regarded as income for the purpose of the income

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\(^99\) See, e.g., U.S. v. Field, 255 U.S. 257, 262 (1920) (Pitney J. citing *Gould* for the proposition that tax acts should not be “extended by implication”); U.S. v. Merriam 263 U.S. 179, 188 (1923) (Sutherland J. using *Gould* as the basis for deciding that sums given to the executor of a will are not to be considered “income”); Crooks v. Harrelson 282 U.S. 55, 62 (1930) (Sutherland J. stating that in taxing acts, adherence to the letter of the law should be applied with peculiar strictness); Weeks v. Sibley, 269 F. 155, 158 (1920) (D. N.D. Tex.) (citing *Gould* to support the contention that courts must uphold transactions even when the are motivated by the desire “to reduce or avoid taxation.”); Studebaker Corporation v. Gilchrist, 244 N.Y. 114, 126 (1926) (Cr. App. N.Y.) (Cardozo J. citing *Gould* for the proposition that a statute levying a tax will not be extended by implication beyond the clear import of its terms”)

\(^100\) See discussion in Kornhauser, “The Story of Macomber,” supra note **, at 64, 67.

tax. Rejecting “technicalities,” Holmes noted that “it is said that the tax laws should be construed favorably for the taxpayers. But that is not a reason for creating a doubt or for exaggerating one.”102 Another example is Untermeyr v. Anderson,103 in which the question was whether a gift given before the enactment of the gift tax provision of the Revenue Act of 1924, but when the legislation was pending, should be subject to the tax. While Justice McReynolds, writing the majority opinion, decided for the taxpayer citing the need to assure certainty in tax law, Justice Brandeis, in his dissenting opinion, argued that since the purpose of the gift tax was to prevent evasion, it would be justified to see it as having a retroactive effect. Citing an earlier opinion by Holmes, Brandeis noted that “in taxation, as well as in other matters, the law allows a penumbra to be embraced that goes beyond the outline of its object in order that the object may be secured.”104 Brandeis’ approach was substantially adopted in a 1931 case, Milliken v. United States.105

By the early 1930s, the courts were already stating that in cases of doubt, the fact that a certain meaning could lead to tax avoidance would prompt them to interpret the statute in favor of the government. Woolford Reality v. Rose, decided in 1932, was a case in which the taxpayer wanted to deduct the losses of one corporation from the income of

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102 Irwin v. Gavit, 268 U.S. 161, 168 (1926). The dissent in this case (Sutherland J.) argued that the taxpayer “is entitled to the rigor of the law. There is no latitude in a taxing statute – you must adhere to the very words.” Adding that the court’s opinion should have been based on “the strict letter of the statute.”

103 276 U.S. 440 (1928).

104 Id., at 445, 450-1 (citing Schlesinger v. Wisconsin, 270 U.S. 230, 241 (1926)).

105 283 U.S. 15 (1931)
an affiliated corporation. Justice Cardozo declared that such losses could not be deducted arguing that

a different ruling would mean that a prosperous corporation could buy the shares of one that had suffered heavy losses and wipe out thereby its own liability for taxes. The mind rebels against the notion that Congress in permitting a consolidated return was willing to foster an opportunity for juggling so facile and so obvious. Submission to such mischiefs would be necessary if the statute were so plain in permitting the deduction as to leave no room for choice between that construction and another. [But] expediency may tip the scales when arguments are nicely balanced.\textsuperscript{106}

In a 1933 case, \textit{Burnet v. Guggenheim}, Justice Cardozo basically negated the rule that in cases of doubt tax statutes should be interpreted in favor of the taxpayer. In response to the taxpayer’s citing this rule, he explained that “there are many facets to such a maxim. One must view them all, if one would apply it wisely. The construction that is liberal to one taxpayer may be illiberal to others. One must strike a balance of advantage.”\textsuperscript{107}

The general movement from a pro-taxpayer to a pro-government approach to tax interpretation can also be illustrated by comparing treatise discussions of the issue. While judges deciding a specific case can chose a canon of statutory interpretation that fits their

\textsuperscript{106} 286 U.S. 319, 330 (1932).

\textsuperscript{107} 288 U.S. 280 (1933).
specific need and ignore contradictory canons, textbook writers summarized all or many cases on the subject and thus were more aware of the conflicting approaches of the courts. The result is that treatise writers tended to mention both pro- and anti-taxpayer canons and then chose some middle ground. Still, the exact location of this middle ground seems to have shifted as time passed. When one reads the treatises, a decline in the importance of the narrow/pro-taxpayer canon is noticeable.

This decline is apparent when comparing the leading late 19th century treatise on taxation, Cooley’s *A Treatise of the Law of Taxation* first published in 1876108 with a leading 1930s treatise on federal income taxation, Randolph Paul and Jacob Mertens’ *The Law of Federal Income Taxation*.109

In the chapter of tax interpretation in his treatise, Cooley observed that the general rule in England and in the United State was that in cases of doubt, tax laws should be interpreted in favor of the taxpayer.110 He then noted that some decisions seemed to indicate a different, pro-government, approach, but argued that such an impression was misleading or contrary to established precedents.111 He then stated that the interpretation of revenue laws should favor neither the taxpayer nor the government, but that ultimately

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108 THOMAS M. COOLEY, A TREATISE ON THE LAW OF TAXATION (1876). There are later editions of this book, the fourth and last of which was published in 1924. The chapter on tax interpretation in this last edition is substantially similar to the chapter in the first edition (apart from the addition of new cases).


110 COOLEY, supra note **, at 200-2.

111 Id., at 203-5.
in cases of doubt, the courts should be strict or lean in a pro-taxpayer direction because of the presumption that the legislature expressed in the law what it intended to express and was at hand to explain the meaning of the law and to clarify what was obscurely expressed. Thus while Cooley did not subscribe to an outright pro-taxpayer rule, there was certainly a pro-taxpayer tilt in his formulation.

In Paul and Mertens’ book on federal income taxation, published in 1934 (the year in which Gregory was decided) this tilt was gone. The pro-taxpayer rule was described as an “old rule” and its discussion was relegated to the final pages of the chapter on tax interpretation. In addition, the authors noted that while in the past, the courts interpreted ambiguous statutes in favor of the taxpayer, since tax avoidance had become common, “the tide has somewhat turned” and “the latest tendency of the courts is strongly against constructions which permit tax avoidance.” The reason for this new tendency, they asserted, was that new tax laws and higher rates made avoidance more attractive. While dealing with new instances of avoidance, the courts had learned that the legislative response was often not sufficiently prompt, and only they could “deal with many of these evils” by adopting a more flexible interpretative attitude.

113 PAUL & MERTENS, supra note **, at 63
114 Id., at 37-38.
115 Id., at 38.
Three years later, in an article on tax avoidance, Randolph Paul went even further and asserted that “in interpreting a tax statute the courts will, in their natural and perhaps imposed duty to protect the revenue, adopt an attitude of skepticism as to the meaning urged by a tax-avoiding taxpayer … and will on occasion decide that a statutory provision is not meant to protect the taxpayer who seeks to avoid the burden which would be his but for the provision in question.”\(^{116}\) In a later book, Paul described the gradual shift to a substantive pro-government stance which occurred in the 1930s as a reflection of a more general movement from a formalist, technical approach to a policy-oriented, consequential, substantive approach. It was also, Paul noted, a reaction to the “felt necessity” of preventing tax avoidance.\(^{117}\)

What was Judge Hand’s position in this debate? In May 14, 1933, less than a year before deciding *Gregory*, Hand gave a radio lecture entitled “How Far is a Judge Free in Rendering a Decision?” which summarized his approach to statutory interpretation. In his lecture, Hand argued that judges were not totally free to ignore the letter of the law but nevertheless attacked what he called “the dictionary school,” i.e. those who believed that judges “must follow the letter of the law absolutely.”\(^{118}\) This was not a new stand. Throughout his judicial career, Hand had advocated a less literalist and less formalist approach to statutory construction and indeed he is viewed as one of the early

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\(^{116}\) *Id.*, at 153.

\(^{117}\) *Paul, Taxation in the US*, *supra* note ***, at 659–60
proponents of a policy-oriented perspective of statutory construction.\textsuperscript{119} Perhaps an additional factor for Hand’s disdain for literal interpretation can be found in the specific complexity of tax statutes. In a wonderfully candid discussion of the specific problems of tax interpretation, Hand admitted that

The words of such an act as the Income Tax, for example, merely dance before my eyes in a meaningless procession: cross-reference to cross-reference, exception upon exception – couched in abstract terms that offer no handle to seize hold of – leave in my mind only a confused sense of some vitally important, but successfully concealed purport which it is my duty to extract, but which is within my power, if at all, only after the most inordinate expenditure of time. I know that these monsters are the result of fabulous industry and ingenuity, plugging up this hole and casting out that net, against all possible evasion; yet at times I cannot help recalling a saying of William James about certain passages in Hegel: that they were no doubt written with a passion of rationality; but that one

\textsuperscript{118} Learned Hand, \textit{How Far is a Judge Free in Rendering a Decision?} in \textit{The Spirit of Liberty: Papers and Addresses of Learned Hand} 103, 107 (Irvin Dilliard ed. 1963).

cannot help wondering whether to the reader they have any significance save that the words are strung together with syntactical correctness.\textsuperscript{120}

\section*{II. Anti Avoidance Doctrines}

The conventional starting point of discussions of the history of federal anti-avoidance doctrines is usually taken to be a 1864 case, \textit{U.S. v. Isham}.\textsuperscript{121} This case dealt with the provisions of the Stamp Act of 1864. Discussing this question, the court declared that if a “device to avoid the payment of a stamp duty … is carried out by the means of legal forms, it is subject to no legal censure” and gave an example based on the Stamp Act of 1862 which imposed a duty upon bank-checks drawn for an amount of twenty dollars or more. “A careful individual,” noted the Court

having the amount of twenty dollars to pay, pays the same by handing to his creditor two checks of ten dollars each. He thus draws checks in payment of his debt to the amount of twenty dollars, and yet pays no stamp duty. This practice and this system he pursues habitually and persistently. While his operations deprive the government of the duties it might reasonably expect to receive, it is not perceived that the practice is open to the charge of fraud [upon the revenue].

\begin{footnotes}
\item[120] Learned Hand, \textit{Thomas Walter Swan}, 57 YALE L. J. 167, 169 (1947).
\item[121] 84 U.S. 496 (1864). \textit{See also Effective and Lawful Avoidance of Taxes}, 8 VA. L. REV. 77, 79-80 (1921); \textit{JOHN H. SEARS, MINIMIZING TAXES} 3-4 (1920) (discussing the case). It should be noted that the term
\end{footnotes}
The court justified this position using a policy argument to sustain this result, noting that “the adoption of a rule that the form of the instrument can be disregarded, and its real character be investigated for the purpose of determining the stamp duty, would produce difficulties and inconveniences vastly more injurious than that complained of” and would be “impracticable in a commercial country.”

Like the Supreme Court, some 19th century state courts adopted a formalist approach. Thus changes in residence, the use of foreign corporations, the creation of indebtedness or the use of gifts to avoid state property taxes were upheld by some state courts which refused to examine the underlying tax reduction motivation of the taxpayer.

However, there were also occasions when the Supreme Court and lower federal courts as well as some state courts did intervene in cases of tax avoidance. Thus, the courts intervened in cases where money was deposited for a short period of time in a special account not subject to taxation or invested for a short period of time in tax-free securities only in order to minimize the assessed property of a taxpayer. Courts also intervened when property was formally removed from a taxing district without

“avoidance” was not part of legal discourse in 1864 and therefore the case was framed as a “fraud upon the revenue” case.

122 U.S. v. Isham, 84 U.S. 506-7 (1864).
123 Sears, supra note **, at 5-14.
relinquishing actual control, or when a taxpayer sold an insignificant part of a lot to evade paving or street-improvement taxes.  

In the early 20th century, a more formalist position gained strength. One manifestation of this was the landmark 1916 Supreme Court case, Bullen v. Wisconsin, in which the issue was whether the State of Wisconsin could impose an inheritance tax on funds belonging to a resident of Wisconsin which were held in a revocable trust in Chicago. While Justice Holmes in his opinion declared that the fund was subject to the tax, he also used a clear-cut dichotomy between legal avoidance and illegal evasion stating that

We do not speak of evasion, because, when the law draws a line, a case is on one side of it or the other, and if on the safe side is none the worse legally that a party has availed himself to the full of what the law permits.  

In another well known Supreme Court case decided in the 1920s, U.S. v. Merriam, the Government tried to argue that “taxation is a practical matter and concerns itself with the substance of the thing upon which the tax is imposed rather than with legal forms or expressions.” However, Justice Sutherland, basing himself on Gould, explicitly rejected

124 Id., at 18-25

this argument.126 This was also the position of lower federal court cases and the Board of Tax Appeals.127

During this period the courts sometimes adopted a substantive approach. This approach was often used to reach a pro-taxpayer result.128 But a substantive approach also led to decisions in favor of the government in the Supreme Court,129 and in lower federal courts.130 The 1920s also saw a growing concern in Congress with the problem of tax evasion.131

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126 U.S. v. Merriam 263 U.S. 179,187 (1923). The formalism of the Court sometimes led to pro-government decisions such as the those found in the early 1920s reorganization cases discussed in Bank, Mergers, supra note **, at 22-8.

127 See, e.g., Weeks v. Sibley, 269 F. 155, 158 (1920) (D. N.D. Tex.) (a dissolution of a corporation, the transfer of its assets to a trust and the subsequent sale of trust property and periodical distribution of the profits all in order to avoid taxation is legitimate and is “altogether different from tax dodging, the hiding of taxable property, or the doing of some unlawful or illegal thing in order to avoid taxation”); Appeal of Peterson and Pegau Banking Co. 2 B.T.A. 637, 639 (1925) (affirming the “right of any taxpayer to minimize its taxes by legitimate devices”). For a critical discussion of this “right” from an economic perspective, See Weisbach, Ten Truths, supra note **, at 220-2 (noting that the discussion of a “right to tax plan” is misleading since neither moral philosophy nor the Constitution, nor any express statutory provision of Congress has recognized such a “right”). For a critique of Weisbach’s position see Schler, supra note **, at 384-88.

128 See, e.g. Southern Pacific Company v. Lowe, 247 U.S. 330 (1918) (Pitney J. declaring that dividends paid in 1914 by a wholly-owned subsidiary to its parent company from profits made before the 1913 income tax act came into effect may be formally income but in “truth” and in “substance” they belonged to the parent company before 1913 and therefore could not be taxed by the 1913 income tax act); Gulf Oil Corp. v. Llewellyn 248 U.S. 71 (1918) (Holmes J. declaring that one should ignore forms when analyzing the taxable nature earning transferred for bookkeeping purposes from subsidiaries to a holding company); Weiss v. Stearn, 265 U.S. 242 (1924) (a reorganization in lieu of sale in which stockholders received part of the consideration for their stock in shares rather than in cash in which McReynolds J. held, using substantive rhetoric, that the shares were not taxable income. Holmes and Brandies dissenting); Prairie Oil & Gas Co. v. Motter, 66 F. 2d 309 (C.C.A. 10th, 1933) (“taxation is an intensely practical matter and that the substance of the thing done, and not the form it took, must govern”).

129 Horning v. District of Columbia 254 U.S. 135 (1920) (a Washington pawnbroker who attempted to escape a license fee in the District of Columbia moved part of his business to Virginia, retaining most of his operations in the District of Columbia. The Supreme Court held that this was ineffectual to escape the DC fee).

130 Appeal of W. C. Bradley , 1 B.T.A. 111, 117 (1924) (stating that “the law … deals not alone with the form but with the substance of transactions, looks if necessary through the form to the substance, and predicates its findings upon realities rather than upon fictions”); U.S. v. Barwin Realty Co. 25 F.2d 1003
avoidance and tax legislation soon became full of provisions designed to foil the tax avoidance schemes of the taxpayers.\textsuperscript{131}

It seems, however, that the significant shift to a substantive anti-taxpayer approach occurred only in the early 1930s, in such Supreme Court cases as Superior Oil \textit{v. Mississippi},\textsuperscript{132} Corliss \textit{v. Bowers}\textsuperscript{133} as well as Pinellas Ice \& Cold Storage Co. \textit{v. Commissioner}, a continuity of proprietary interest case dealing with the reorganization provisions of the 1926 Revenue Act.\textsuperscript{134} In some Second Circuit cases from the early 1930s the same approach was also evident. One example is found in a 1932 dissent by Augustus Hand, Learned Hand’s cousin, in a case of a revocable trust called \textit{Langley \textit{v. Commissioner}}.\textsuperscript{135}

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(1928) (D. E.D. N.Y.), affd 29 f. (2d) 1019 (“where the corporate form is used for the purpose of evading the law, the court will not permit the legal entity to be interposed so as to defeat justice”).
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\textsuperscript{132} 280 U.S. 390, 395-6 (1930) (discussing a scheme for the avoidance of a Mississippi gasoline tax in which Holmes adopted a substantive approach because “it is important…not to deprive the States of their lifeblood by a strained interpretation of facts.”)

\textsuperscript{133} 281 U.S. 376 (1930).

\textsuperscript{134} 287 U.S. 462 (1933). In this case a corporation transferred most of its assets to another corporation in return for cash and short-term promissory notes. The taxpayer claimed that this was a tax-free reorganization and not a taxable sale. There are other Supreme Court cases from this period which adopt a substantive approach. \textit{See}, e.g., Reinecke \textit{v. Smith}, 289 U.S. 172 (1933) (Roberts J. rejecting a constitutional challenge to a statutory provision taxing the income from revocable trusts); Burnet \textit{v. Wells}, 289 U.S. 670 (Cardozo J. and Roberts J. rejecting a constitutional challenge to a statutory provision taxing the income from revocable trusts noting that “in this and other cases there has been a progressive endeavor by the Congress and the courts to bring about a correspondence between the legal concept of ownership and the economic realities of enjoyment or fruition…[and] only by closing our minds to common modes of thought, to everyday realities, shall we find it in our power to for another judgment”).

\textsuperscript{135} 61 F. 2d 796 (1932). Section 166 of the Revenue Act of 1928 taxed the income of the grantor of a trust if the grantor had “at any time during the taxable year … the power to revest in himself title.” The trust agreement in question contained a provision granting power of revocation, but requiring a notice of a year and a day before this power came into effect. The majority of the court (Manton and Chase) decided that section 166 of the Revenue Act was inapplicable because Congress could have explicitly taxed such a
Another example was *Cortland Specialty Co. v. Commissioner*, a 1932 case.\(^\text{136}\) This, like *Pinellas*, was a continuity of proprietary interest case which was decided by a panel which included the two Hands. Learned Hand relied on both *Pinellas* and *Cortland* when he decided *Gregory*. Of course, some 1930s cases still adopted a pro-taxpayer and formalist attitude.\(^\text{137}\)

But the trend in the 1930s on the whole seems to have been to move to a substantive attitude which was simultaneously less tolerant attitude to tax avoidance. The same shift was evident in the new administrative vigor in pursuing tax avoidance.\(^\text{138}\)

Contemporary observers discussing the development of anti-avoidance doctrines thus saw a more or less linear progression from formalism to substance. According to Paul Marcuse, writing in the late 1930s, “two distinct theories [on tax avoidance] are

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136 60 F. 2d 937 (1932). In this case too the assets of one corporation were acquired for cash and short-term notes of a second corporation. The Second Circuit decided that this was a sale and not a reorganization. For similar attitudes in Board of Tax Appeals decisions from the early 1930s see *Arctic Ice Machine Co. v. Commissioner*, 23 B.T.A. 1223 (1931) (in which the court rejected the taxpayer’s attempt to designate a taxable sale as a tax-free reorganization, basing the decision on “the substance of the transaction rather than its mere form.”)

137 See, e.g., *Iowa Bridge Co. v. Commissioner*, 39 F. 2d 777 (1930) (unless fraud exists, the fact that a corporation attempts to avoid its taxes is not a reason to recharacterize the transaction); *Jones v. Helvering* 63 App. D.C. 204 (1934) (stating that “it has been the invariable holding that a taxpayer may resort to any legal method available to him to diminish the amount of his tax liability”); *Commissioner v. Eldridge*, 79 F. 2d 629 (1935) (citing *Gregory* in support of the proposition that “a taxpayer may resort to any legal method available to him to diminish the amount of his tax liability.”); *Satwell v. Commissioner* 82 F. 2d 221 (1st cir. 1936) (Morton J. stating that “nothing is better settled than that persons are free to arrange their affairs to the best advantage for themselves under the law as it stands. A purpose to minimize or avoid taxation is not an illicit motive.”); *Helvering v. Clifford*, 309 U.S. 331 (1940) (Roberts J. dissenting stating that “courts ought not to stop loopholes in an act at the behest of the Government”)

138 Paul, *Restatement*, supra note **, at 62-64 (discussing various administrative measures to fight avoidance in the early 1930s).
apparent” in the decisions of the courts: The older “conservative” theory is “decidedly still under the pioneer spirit.” This theory was embodied in Holmes’ famous saying in *Bullen* that “we do not speak of evasion, because when the law draws a line, the case is on one side of it or on the other, and if on the safe side, it is none the worse legally that a party has availed himself to the full of what the law permits.” There was, however, said Marcuse, a “newer” or “liberal” theory according to which the court “would not permit the use of a mere form for the purpose of evading” taxes.

The trend in the cases was often understood as part of a wider movement of mature systems from formalism to “equity.” Thus, in an article on tax avoidance written in 1937, Randolph Paul discussed “avoidance in other fields of law” (avoidance of anti-usury legislation) and concluded that these instances are but samples of avoidance in the general field of law.

They serve the purpose of reminding us that avoidance has a wider

139 240 U.S. 625, 631 (1916).

140 Marcuse, *supra* note **, at 558-9. See also Paul, *Restatement, supra note **, at 61-2 (discussing changing judicial attitudes to tax avoidance. In this discussion, Paul cited 20 cases as evidence that the courts were contributing their share to the battle against tax avoidance. Of these 20 cases, 18 were decided between 1931 and 1936); Roger John Tramynor, *State Taxation and the Supreme Court, 1938 Term* 28 CAL. L. REV. 1 (1939-1940) (noting the “march of [recent] decisions concerned with … undue immunities of many citizens from their obligations to support their governments”); Harry J. Rudick, *The Problem of Personal Income Tax Avoidance, 7* LAW & CONTEMPORARY PROBLEMS 243, 262, 264 (1940) (writing that “today [1940]…all three branches of the government – legislative, administrative and judicial [are] hot on the trail of the tax avoider” and that that as a result of the cases of the 1930s “forms are likely to prove a poor shelter against tax” because today the judicial approach is a “realist one.”)

141 Such an interpretation can be seen as analogous to the previously mentioned “progressive” (or Whig) uni-directional version of the history of income tax legislation according to which the history of taxation in the 20th century is the story of the gradual victory of the people or “democracy” against wealth.
horizon than taxes. They suggest the thought that the history of law has repeated its processes in tax law, starting with highly technical, straight-laced formulae which as they proved too rigid, were discarded in favor of more elastic attitudes – the classic journey from law to equity.¹⁴²

The conviction that there was a uniform trend in the cases led some commentators to argue optimistically that “avoidance is a dead letter [because] Congress need only impose a tax and the Court will stand guardian to see that it is not avoided” and that therefore tax avoidance was “in the twilight”.¹⁴³

It seems that my doctrinal discussion puts an end to the need for further research. *Gregory* was not revolutionary. It was part of a long line of cases on tax interpretation and tax avoidance which logically led to the result that Hand reached. It can be thus explained solely by internal doctrinal developments without any need to discuss other factors. Unfortunately, this is not the case. In the next section, I will argue that internal doctrinal developments alone cannot explain the decision in *Gregory* for two reasons: First, because Hand’s decisions on tax avoidance before and after *Gregory* are not consistent with the theory that he held a coherent position on tax interpretation and tax avoidance. Instead, when one examines the micro-level of doctrinal development, the picture is one of chaotic, quantum-mechanics-like movement instead of clear trends. Secondly, when one

looks beyond the cases to the professional literature, it appears that in the 1930s two contradictory trends were at work; while some judges were adopting a less tolerant attitude to tax avoidance, a contradictory trend appeared in the professional legal literature; a movement towards a clearer distinction between permissible avoidance and impermissible evasion. Thus the story of legal development in the 1920s and 1930s is not a coherent story of a clear linear development but rather an ambivalent tale of contradictory trends.

III. Can the Legal Context be the Sole Explanation?

1. Pre-Gregorian and Post-Gregorian Decisions by Hand

It is impossible to find a coherent or linear attitude in Learned Hand’s approach to tax interpretation and tax avoidance. In the months immediately before and after Gregory was decided, Hand adopted positions which were opposite to those he adopted in Gregory. Thus, a mere two months before he decided Gregory, Hand was using a literal

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144 Maybe one of the reasons was that Learned Hand, despite being one of the leading tax judges of his time, was in fact sometimes also baffled by tax law. Learned Hand’s clerk in 1934-5, Arthur L. Dougan, told Hand biographer Gerald Gunther that “tax cases consisted the nearest to a weakness [in Hand] … I never felt he had overall mastery of the subject which he had in other areas.” See Hand Papers, Harvard Law School, file 52-11, Arthur L. Dougan to Gerald Gunther, January 8, 1970. Perhaps one should also mention the preface to a 1937 book on tax avoidance, in which Jerome Frank said that “I have heard one of our ablest Federal appellate judges say that he cannot remember, from one term to another what he decide in income tax cases because they are so dull.” See Jerome Frank, Introduction in R. Paul, Restatement, supra note **, at 1. It is not clear if Frank was referring to Hand but based on Hand’s later confession in his obituary to Judge Swan about the inscrutability of tax legislation (See note **) perhaps one may speculate that Hand was the judge whom Frank was quoting.
approach to tax interpretation,\textsuperscript{145} and less than a year before \textit{Gregory}, one can find him arguing (just as the respondent and Judge Sternhagen of the Board of Tax Appeal argued in \textit{Gregory}) that the detailed provisions of the tax acts leave little leeway for any purposive interpretation.\textsuperscript{146}

The same can be said about Hand’s post-Gregorian opinions. As Marvin Chirelstein has already shown in his discussion of Learned Hand’s tax avoidance decisions, \textit{Gregory} did not represent a final substantive terminus of Hand’s doctrinal development. Indeed, soon after \textit{Gregory} was decided, Hand reverted to a more conservative approach to tax avoidance in \textit{Chisholm v. Commissioner}, decided in July 1935.\textsuperscript{147} This was a case in which two brothers wanted to sell some appreciated securities they owned. In order to minimize their taxes they transferred the shares to a partnership which subsequently sold them. They did so on the advice of their attorney who told them that by forming a partnership they might escape taxation since the existing rule deferred the tax on the appreciated amount until the dissolution of the partnership. The Board of Tax Appeals found for the

\textsuperscript{145} \textit{See}, e.g., Bliss v. Commissioner, 68 F. 2d 890, 893 (January 8, 1934) (Hand dissenting, arguing for a literal interpretation of a provision dealing with the computation of a deduction for charitable purposes). \textit{See also} Hand Papers, File 192-3, Old Colonial Ice v. Commissioner Memo by Hand, January 16, 1933 (“I think form should govern”); Hand Papers, File 192-18, Bandes v. Commissioner, Memo by Hand February 15, 1934 (supporting a literal interpretation).

\textsuperscript{146} \textit{See} Delaware & Hudson Co. v. Commissioner 65 F. 2d 292 (June 5, 1933) (arguing that “a taxing system so detailed and particular as ours does not admit of the same flexibility of interpretation as one in more general terms. Perhaps its very refinement may defeat its purpose; elaboration often does. But the more articulate the expression, the less room remains for intendment beyond the words used”). Judge Sternhagen of the Board of Tax Appeals justified his decision in \textit{Gregory} by arguing that “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.” \textit{Gregory} v. Helvering, 27 B. T. A. 223, 225 (1932).

\textsuperscript{147} \textit{See} Chirelstein, Contribution, \textit{infra} note **, at 446-7
Commissioner, based on the argument that the transaction was not “bona fide.” The decision of the Board was reversed by Hand. Hand distinguished this case from *Gregory* by noting that the partnership in this case had continued existence unlike the transitory nature of Averill, the corporation discussed in the *Gregory* case.148 But the real reason that Hand distinguished *Chisholm* from *Gregory* may be found in the memos of the three judges who decided the case. These memos reveal that the judges apparently felt that they had released the substantive genie from its bottle and that they regretted having done so. In his memo, Hand wrote that

I have a feeling in my bones that the Supreme Court would support this tax saying that the transaction was a ‘sham’ and letting it go at that. At first it seemed to me plainly such a case, but the longer I study it the less escape I can find without overturning what ought to be pretty solid foundations. If these tax dodgers had dissolved their blessed firm soon after it was formed … I should have held that this was implicit between them … but we should have no ground to hold anything of the sort as things are. We shall never get any order in this subject if we rest in the word ‘sham’ or in such meaningless chatter as that of Arundell [the Board of Tax Appeals Judge] here.149

148 79 F. 2d 14 (2d cir. 1935).
And Augustus Hand, one of the other judges, was even more explicit, saying in his memo that:

I think we are on dangerous ground if we upset the above transaction though very likely we shall get spanked by the celestial altitudinous moralists if we do not. Let Congress legislate if it wishes and, it is to be hoped, not make mere intent to save payment of taxes the test. I suppose my associates will be sorry for what [former New York] Mayor [William Jay] Gaynor called my ‘inconspicuous morality’ and lack of faith in a higher law, but I can’t help it.\footnote{Hand Papers, Harvard Law School, file 194-10 Chisholm v. Commissioner, Augustus Hand Memo, May 27, 1935. The third Judge, Harrie Chase, referred in his memo to the “ethereal heights” of \textit{Helvering v. Gregory} although he hastened to add that that decision was “righteously affirmed at the first opportunity by the Supreme Court.” See Hand Papers, Harvard Law School, file 194-10 Chisholm v. Commissioner, Harrie Chase Memo, not dated.}

2. The Rise of the Evasion/Avoidance Dichotomy and the Appearance of Professional Tax Avoidance Literature

As tax interpretation and anti-avoidance doctrines were being transformed by the courts, a contradictory development occurred in the professional legal literature: a formal dichotomy emerged between avoidance and evasion, and tax avoidance became the respectable subject of technical professional discussions.
The term “tax avoidance” is a 20th century invention. 151 19th century cases do not use it. For example, the leading 19th century case on avoidance, *Isham*, was framed as a criminal case of evasion or, more technically, as a “fraud upon the revenue” case. 152 19th century legislation also used the term “evasion” when they meant avoidance. 153 Even in the 1916 landmark case, *Bullen*, Justice Holmes, while implicitly introducing the distinction between evasion and avoidance, did not explicitly use the term “avoidance.” 154

When courts began using the term “avoidance”, they often used it to mean “evasion.” This can be seen in a 1920 lower federal court case, *Weeks v. Sibley*, in which the Court referred to “tax dodging, the hiding of taxable property, or the doing of some unlawful or illegal thing in order to avoid taxation,” 155 or in a 1920s Board of Tax Appeals case which used both terms interchangeably, saying that “tax evasion is as old as the tax-gatherer, and the would-be evader has not infrequently tested in the courts the product of his fertile brain. If his plan really avoids the tax, if he actually conducts his operations outside the scope of its effectiveness, his device is said to be avoidance.” 156

151 For an exhaustive survey of the use of the terms evasion and avoidance in pre-1940s case-law see Paul, Restatement, supra note **, at 12-19
152 U.S. v. Isham, 84 U.S. 496, 506 (1864)
153 See, e.g., Sears, supra note **, at 21.
155 269 F. 155, 158 (1920) (D., N.D. Tex.)
156 1 B.T.A. 111, 118 (1924).
The same can be said about the professional legal literature. 19th century law review literature did not contain any discussion of either tax avoidance or tax evasion. The terms (and the issue of avoidance) were simply not a part of the legal discourse of the time.\textsuperscript{157} The first discussion of the issue that I found in the law review literature is a note published in 1900 in an English law journal. This note stated that “evasion” is doing something which is “legally and morally culpable” and that therefore the use of gifts to escape estate duty cannot be deemed evasion (the term “avoidance” does not appear in this note).\textsuperscript{158}

Only in the 1920s did the issue of tax avoidance become a topic for extended discussions in the law review literature. In the early discussions, the dichotomy was not used. The first articles devoted to the subject still contained a tone of surprise at the fact that taxes can be “evaded” legally. This is clear from the title of a 1921 Virginia Law Review article: “Effective and Lawful Avoidance of Taxes.”\textsuperscript{159} This article was one of the first attempts to distinguish between “lawful and effective” tax avoidance and “forbidden evasion”. A year later, a book on “tax minimization” already took the “fundamental

\textsuperscript{157} This observation is based on a search of Hein-on-line, a database of historic law reviews articles done in July and August 2002. The database contains about 75 journals published before the 1940s. The terms searched were “tax avoidance”, “tax evasion”, “tax planning”, “tax minimization”, “tax fraud”, “fraud upon the revenue”, “tax mitigation” and “tax loopholes”. The journals contained in the database are legal journals. A study of the accounting and business literature of the period may yield different results.


\textsuperscript{159} \textit{Effective and Lawful Avoidance of Taxes}, 8 VA. L. REV. 77 (1921).
difference between avoidance and evasion” for granted,160 and so did subsequent articles and books.161 But there are later examples that show that the terminology had not yet been assimilated by the legal community,162 let alone by Congress163 or the general public.

In the early 1920s, relatively few articles, books or book chapters discussed the issue. Tax planning certainly existed but its practitioners were not keen to write about it publicly.164 Thus the acknowledgement section of one of the first books devoted to the subject stated that “those to whom these [tax avoidance] plans [which are described in the book] belong gave them freely to us, knowing that no confidence would ever be abused. This explains the absence of names.”165

160 Sears, supra note **, at iii.

161 See James L. Dohr, Avoidance vs. Evasion of Tax Liability, 6 NATIONAL INCOME TAX MAGAZINE 1 (1928); JOSEPH J. KLEIN, FEDERAL INCOME TAXATION 1729 (1929); DENNIS HARTMANN, TAX AVOIDANCE (1930).


163 Latham, supra note **, at 30, 38

164 Hartmann, supra note **, at 29.

165 CLINTON DAVIDSON, MINIMIZING TAXES AND AVOIDING CAPITAL LOSSES IN ESTATES iii (1929).
The subject came into the open only in the 1930s. The first manual on tax planning which I was able to find was published in 1922. Others soon followed. In Dennis Hartmann’s forward to his 1930 book on the subject, he noted that the rise of a new business of tax planning is not more than “two or three years” old. By the middle of the 1930s, the distinction between evasion and avoidance and the legitimacy of avoidance were well established, at least in the professional legal literature. There was even talk of “the law … of tax avoidance.” Indeed, it was so well established that the

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166 A search of the occurrence of the terms “avoidance” and “evasion” in the Hein-on-line database conducted in July and August 2002 yielded the following results (other synonymous terms rarely appear in the database):

167 See Hartmann, supra note **, at 29.

168 See, e.g., Davidson, supra note **; A. H. BERGER, 107 PRACTICAL METHODS OF MINIMIZING PAYROLL TAXES (1936); J. BLAKE LOWE & JOHN D. WRIGHT, MINIMIZING TAXES ON INCOMES AND ESTATES (1937).

169 Hartmann, supra note **, at 1, 63. On the growing role of accountants in tax planning in the 1920s see GARY PREVITS AND BARBARA MERINO, A HISTORY OF ACCOUNTANCY IN THE UNITED STATES 254-6 (1998).

170 See, e.g., George T. Altman, Recent Developments in Income Tax Avoidance, 29 ILL. L. REV. 154, 157 (1934-5)

171 See RANDOLPH PAUL, STUDIES IN FEDERAL TAXATION: TAXATION WITHOUT MISREPRESENTATION 9-12 (1937).
first legal realist critiques of the distinction between evasion and avoidance began to appear.\footnote{172}

The gradual emergence of tax avoidance as a professional legal concern does not imply that tax avoidance did not exist before the 1920s nor does it imply that tax avoidance was not an important political and economic issue. Tax evasion and tax avoidance are as old as taxation itself (although the reintroduction of a federal income tax in 1913 certainly increased the incentive to avoid taxation).\footnote{173} Avoidance was also a major concern of politicians and economists in the 1920s. During the 1920s, Democrats and Republicans vigorously debated the issue. The Democrats argued that the major problem was corporate tax avoidance by various methods such as undistributed corporate profits. The Republicans argued that the major vehicle for tax avoidance was the use of tax exempt State and municipal bonds. Andrew Mellon, the Pittsburgh millionaire and Secretary of the Treasury between 1920 and 1932, argued that since state and local bonds enjoyed a constitutional immunity from federal taxation, the only effective way to fight widespread avoidance was a drastic lowering of income tax rates and indeed Mellon’s proposals were put into effect in 1924 and 1926 and marginal rates were dramatically

\footnote{172 See \textit{id.}, at vi (“it seems clear that a lot of long-standing dogmas were wrong or at the best insufficient; that tax avoidance and tax evasion are not simple categories enabling quick, unhesitating pigeon-holing; that courts often look in the back of the book and then use their best words and phrases for window dressing.”)}

\footnote{173 See, e.g. Bank, \textit{Entity Theory}, supra note **, at 508-11, 519-22 (discussing widespread evasion and avoidance of 19th century property taxes).}
lowered. Economists too were interested in the issue and one does find discussions of it in the economic literature.

However, it seems that the political and economic discussions of avoidance in the 1920s had little impact on the professional legal literature. By the 1930s, the distinction between evasion and avoidance was deeply rooted in the collective mind of the legal profession. In June 1937, President Roosevelt directed public attention to the issue by giving an address which condemned tax “evasion” by the extremely wealthy. Law review article writers reacted by calling on the President to make a clear distinction between evasion and avoidance, berating him and the Secretary of Treasury for “confusing” lawful avoidance with immoral and unlawful evasion. No moral culpability could be attached to someone who was acting within the letter of the law, it was argued.

In conclusion, when one surveys the legal landscape of the early 1930s, one can sense contradictory trends. On one hand, there seems to have been a trend toward a less literal approach to tax interpretation and to a less formalist approach to tax avoidance. Such a

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174 The highest marginal federal income tax rate in 1921 was 73%. In 1925 it was 25%. See, generally, Gene Smiley and Richard H. Keehn, Federal Personal Income Tax Policy in the 1920s, 55 Journal of Economic History 285, 286-90 (1995), (discussing the debates on tax avoidance in the 1920s).


177 Montgomery B. Angell, Tax Evasion and Tax Avoidance 38 Colum. L. Rev. 80, 86, 89 (1938).
trend could easily explain why Hand adopted a purpose-based approach to the issue at hand in *Gregory*. On the other hand, Hand’s decisions before and after *Gregory* do not show a consistent determination to adopt a non-literal/anti-formalist approach to tax avoidance. Instead they seem to proceed in a non-linear fashion.\(^{178}\)

In addition, during the period when the courts were slowly moving toward a less conservative approach to tax avoidance, professional legal discourse was moving in the opposite direction toward a clearer distinction between illegitimate evasion and legitimate avoidance. These contradictory trends may explain the ambivalence of *Gregory* – the fact that the case included both a declaration about the right to avoid taxation (“any one may so arrange his affairs so that his taxes shall be as low as possible”) but also a purpose-based approach which ultimately led to a pro-government result. Why the pull of these two contradictory vectors led to the specific result of this case and not to an opposite result is therefore something which cannot be explained by internal legal factors alone. An external account of non-legal factors which might have influenced the decision must complement the internal one.\(^ {179}\) The next part of the article will examine non-legal factors which may have effected the way Hand decided the case.

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\(^{178}\) This movement may be seen as random. It may also be described as cyclical, in a way similar to the one described in Vermeule’s model. However, it should be noted that Vermeule’s discussion appears to be focused on changes taking place over a period of decades and not months.

\(^{179}\) See, e.g., Cushman, *infra* note **, at 3-7 (an approach based on a respect for externals accounts of the history of constitutional law developments during the New Deal but also on the insistence that this account be augmented by internal doctrinal contextualization).
III. NON-Legal Factors

There are a number of non-legal factors which might have influenced the decision in *Gregory*. One such factor is the administrative capabilities of the tax collection machinery. I have argued elsewhere that tax avoidance doctrines are sometimes effected by an awareness of the limited capabilities of the Revenue. Thus, when tax authorities are relatively weak and lack the professional capabilities to tackle sophisticated tax avoidance schemes, judicial doctrines will also adopt a passive, formalist stance. When tax authorities develop the appropriate willingness and capabilities, judicially-made tax doctrines will change to reflect the administrative change. 180 This argument may also be relevant to the history of *Gregory*. Some observers have argued that the lack of interest in tax avoidance prior to the 1930s can be explained, among other things, by the fact that the Bureau of Internal Revenue was a relatively small organization and therefore less able to deal with issues of avoidance. 181 Perhaps the growing willingness of the courts to deal with tax avoidance was partly a reaction to the increased capabilities of the Bureau of Internal Revenue in the 1930s.

Another possible factor which influenced Hand’s approach in *Gregory* may have been the internal psychological dynamics of tax litigation. The argument that psychology plays an important role in the process of adjudication, including tax avoidance adjudication, is


not new. One specific form which this argument sometimes takes is to see judicial decisions in this area as a result of the desire of judges not to appear naïve. In an article which criticizes the use of the form/substance dichotomy in tax law, Joseph Isenberg argued that one of the reasons that this dichotomy took hold was the psychological vanity of judges: “the painstaking process of examining transactions and statutes to determine whether they concord promises little glory. In a society that has always looked to courts for strokes of statesmanship, it is easy enough to understand a judge's temptation to cut through, rather than unravel, the Gordian knot. A simpler variant of this attitude is the desire not to look naive, to understand what is ‘really going on’. Many of the judges who have written opinions in this area display the tone of one who wants very much not to be taken in.”

There may be additional psychological factors. A judge who has been audited

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182 Jerome Frank, the legal realist scholar who was later one of Hand’s colleagues on the Second Circuit bench wrote an introduction to a book on tax avoidance published in 1937. In his introduction, he rejected the position that judicial behavior can be ascribed only to “current political and economic forces” and argued that “non-rational factors that are neither economic nor political” also effect the conduct of judges. See Frank, id., at 5.

183 Isenberg, supra note **, at 882. Isenberg goes on to denounce law professors who are “wont to decry ‘formalism’ and glorify the ends of ‘policy’ in the resolution of disputes.” Id., id. For an analogous argument according to which legislators often create norms not in order to effect the real world but as a symbolic communicative gesture which is meant to assist their reelection or just to gratify them as a manifestation of their power, See Shaviro, Beyond Public Choice, supra note **, at 8, 81 (“succeeding legislatively is a means of exercising and demonstrating one's power. It is inherently gratifying (as when an emperor enjoys seeing statues of himself), and it increases one's prestige and status in political circles.” Politicians seek to satisfy a "desire for attention and adulation," they have an "intense and ungratified craving for deference," they "ache for applause and recognition," and they have an "urge for that warm feeling of importance").
by the IRS may develop a pro-taxpayer stance even if he used to support the government before his audit.184

While administrative and psychological factors seem relevant to the history of Gregory, this article will focus on two other explanatory strategies: cultural explanations and the political context. It is not claimed that the cultural and the political are the only ways in which tax avoidance adjudication generally or the history of Gregory in particular can be explained. Instead, the aim of this part of the article is far more modest. Its only aim is to show that a discussion of the role of such factors enriches our understanding of the history of the case.

I. Cultural Explanation: The Morality of Tax Avoidance

In an article about American attitudes to wealth, Marjorie Kornhauser has shown how cultural conceptions of wealth (as both good and evil) shaped American tax law in the late 19th and the 20th centuries in contradictory ways.185 Similar conflicts and contradictions can be found in the attitude of early 20th century Americans toward tax avoidance. In the case of tax avoidance, one can distinguish between periods when an anti-tax avoidance sentiment was more pronounced and periods in which it was less pronounced.

184 I am indebted to Dennis Ventry for this observation.
185 See Kornhauser, The Morality of Money, supra note **.
In the first two decades of the 20th century, it seems that the issue of tax avoidance was often framed in moral terms. For example, John S. Wise, the author of a 1905 treatise entitled *American Citizenship*, argued that tax evaders are un-patriotic, “faithless” and “detestable…cowards.” But the early 1920s saw the rise of a-moral discourse on tax avoidance. In 1921, a *Virginia Law Review* article, which set out to map the distinction between avoidance and evasion, still noted that the public mind confuses the two and views all methods of tax saving as tainted by “moral guilt.” However, argued the author of the article, tax avoidance was “morally right”, because actual tax law diverged from the principles of universal taxation (for example, by taxing corporations more heavily than individuals) and therefore self-help in the form of tax avoidance “tends to make fair what legislators have made unfair.” It helps correct “manifest errors in tax legislation.”

In 1922, John Sears, the author of a book entitled *Tax Minimization*, adopted an unabashedly cynical approach to avoidance. According to Sears, “the ethics of taxation”

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186 THOMAS S. WISE, A TREATISE ON AMERICAN CITIZENSHIP 74 (1906). The same interest in the morality of avoidance was also found in a note published in 1900 in an English Journal, the Law Quarterly Review, in which the author stated that the question of what should be considered tax evasion was a question which at the time “occupies the mind and occasionally distresses the conscience of persons who dread” the estate duty, and the author therefore had to reassure his readers “no man is morally bound” to pay the tax if he can use legal means (such as gifts) to avoid it. *Notes*, 63 L.Q.R. 213 (1900)

187 *Effective and Lawful Avoidance of Taxes*, 8 VA. L. REV. 77 (1921).

188 *Id.*, at 78-9. This idea is somewhat similar to a theme that exists in some of the current economic analysis literature on tax avoidance according to which it is efficient to allow taxpayers to avoid inefficient taxes. See, e.g., Weisbach, An Economic Analysis of Anti-Avoidance Doctrines (mentioning the argument that since some kinds of taxation are inefficient, avoidance of them is efficient). Another indication of the moral aspect of the issue was that some authors of tax planning manuals thanked anonymous tax officials and clients who did not want their names mentioned; See Davidson, supra note **; at iii who reported that some of those who ordered their books requested anonymity. See Hartmann, supra note **; at 2. Of course,
require taxes to be universal. However, since members of Congress and of state legislatures act in the interests of their constituents, taxpayers of “every class” are discriminated against. If these taxpayers have “sufficient political power” they can cause the repeal of the discrimination, but “when taxpayers lack this power” they choose tax avoidance. Sears therefore stated in his introduction that he meant to be “frank and devoid of that mock patriotism which preaches from the taxing power’s vantage point and secretly takes advantage of any loophole in the law,” and went on to imply that it was a patriotic duty to avoid taxation because tax avoidance reveals discriminations and evils in the tax system and helps legal reform: “He who takes the way of a lesser tax helps guide taxation into a safer highway … he hastens the day of recognition of the fact of discrimination; he helps to make prominent evils in the system of taxation.”

Another kind of argument found in some works on avoidance was that the tax authorities themselves supported certain kinds of avoidance. In the introduction to Sear’s book, he thanked anonymous “tax officials” who, he said, helped him write the book. In a 1929 textbook, one of the arguments brought forth to justify tax avoidance was that the American government itself gave advice to American businessmen in order to assist them to minimize foreign taxes and so, presumably, the activity of avoiding (American) taxes

the desire for anonymity may have been motivated by the practical desire not to attract the attention of the I.R.S., rather than by a sense of moral guilt.

Sears, supra note **, at iii-v.
could not be considered illegitimate. Pro-tax avoidance literature also used what may be termed the “professional” argument. Thus, some commentators noted that there is “wide-spread popular sentiment that the skilled tax lawyer is engaged in a reprehensible business” but, that we must not judge the issue based on “undiscriminating popular sentiment.” “The [legal] profession” knows, or should know, that there is indeed a difference between tax avoidance and “tax dodging.” In a similar way, it was argued that tax avoidance cannot be viewed as morally reprehensible because of the fact that “the leaders of the bar are willing to apply their talent to the devising and the defending of means” of tax avoidance, and presumably what the “leaders of the bar” do cannot be immoral.

One clear example of the new approach was found in a book published in 1929 by “the Estate Planning Corporation.” The book was called Minimizing Taxes and Avoiding Capital Losses in Estates. Its chief aim was to convince the reader to obtain the services of the “Estate Planning Corporation.” To that end, the book contained stories on the benefits and perils of estate planning. One such story, “How Eleven Million Became a Hundred Thousand,” told the sad tale of a businessman who failed to foresee the need

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190 Id., at v; Klein, supra note **, at 1731. The assertion that the government advises American businessmen on foreign tax avoidance was repeated in HARTMANN, supra note **, at 27.


192 KLEIN, supra note **, at 1731. See also HARTMANN, supra note **, at 28.

193 DAVIDSON, supra note **.
for estate planning and whose family lost a fortune as a result. The book traced the swift
decline in the fortunes of the family after the death of its head. This decline was caused
by a number of reasons, among them the burden of federal and state estate taxes. The
failure to properly plan, the book warned its readers, resulted not only in financial loss
but also in social ruin:

   Regarded as a financial genius before his death, [the unlucky businessman
whose story was told] had won prestige of no mean order among his
fellow-citizens. He was the president of the Chamber of Commerce,
director in two banks, active in civic organizations. The widespread
admiration and respect in which the community held this man was shared
by all the family. The eldest son was made a director of the Chamber of
Commerce and was active in civic clubs. Then came the father’s death.
His lack of financial foresight began to be revealed – his failure to plan
became known – and almost overnight, that image of prestige, colossal in
life, collapsed like a house of cards. ‘Who would have thought he was
such a fool?’ people said. ‘So shortsighted!’ And even as the family shared
in his glory, so now they shared in his dishonor. From the business that
bore their father’s name, both sons were soon ousted into small clerical
jobs. Civic and social clubs eliminated them from committees, and later
from membership. Today, when they are referred to, it is as the family of
a business fool, whose lack of planning left them not only moneyless, but marked them for social ostracism as well.194

"Every successful man owes it to himself to make [an estate] plan” the book exhorted its readers, “not only for the customary reason of extending his management genius to those left behind, but also for the less obvious reason that no man wishes to be thought a business genius alive, but, because of a muddled and unplanned estate, a fool dead.”195

The sermon-like quality of this story may have had something to do with the fact that the author of the book, a certain Clinton Davidson, was also the author of a book entitled How I Discovered the Secret of Success in the Bible.196 But in any event, what is fascinating about this story is the somewhat perverse link which was now being made between tax avoidance and moral or “honorable” behavior.197 The cultural perception of tax avoidance as an honorable pursuit was also found in a 1939 article which noted that tax avoidance is perceived as an expression of the American way of life: “the old spirit of the pilgrims and the pioneers” viewed government intervention as odious and “as long as

194 Id., at 15-16.
195 Id., at 10.
196 #cite. See also Kornhauser, The Morality of Money, supra note **, at 144 (discussing Bruce Barton’s 1920s book on Jesus as a businessman)
197 The discussion of tax avoidance using the cultural icon of “the prudent businessman” can already be seen in 1920. In Weeks v. Sibley, a 1920 case, the court declared that a dissolution of a corporation, the transfer of its assets to a trust and the subsequent sale of trust property and periodical distribution of the proceeds was not to be taxed, despite the fact that it was evident that the motive for these transactions was the avoidance of taxation, because “it is not unnatural that any thoughtful business man take such steps.” 269 F. 155, 158 (1920) (D., N.D. Texas).
this spirit prevails, it can neither be unpatriotic nor immoral to reduce taxation by means which are not strictly illegal.”

By the 1930s, the issue of the morality of tax avoidance was marginalized in the professional literature. Thus, a 1934 article on “recent developments in income tax avoidance” stated that “there is little in the history or nature of taxes from which to derive a theory of taxation which justifies the moral taint [associated with tax avoidance].” A 1936 book entitled Minimizing Payroll Taxes declared that “it is the privilege and intrinsic right of every taxpayer … to reduce his or her taxes to the legal minimum. Such financial self-preservation is not by any means to be confused with the illegal evasion of taxes.” A 1937 book declared that advice on minimizing taxes should not be subject to “moral or legal censure.”

Popular and even some professional discussions of tax avoidance, however, were often framed in moral terms, especially after the economic boom of the 1920s was replaced by the Depression. Thus, in the final days of the Hoover administration in 1932, Congress debated an increase in estate tax rates and a proposed gift tax. Naturally, there

198 See Marcuse, supra note **, at 556.
199 See James L. Dohr, Avoidance vs. Evasion of Tax Liability, 6 NATIONAL INCOME TAX MAGAZINE 1, 20 (1928) (which mentioned, at the end of the article, the fact that the question was also an “ethical” one but said that that no consideration will be given to the ethical dimension).
200 Altman, supra note **, at 154.
201 BERGER, supra note **, at 5.
202 Lowe & Wright, supra note **, at xi.
203 Secretary Mill's Speech on Tax Measure, N. Y. TIMES, Mar. 3, 1932.
was a surge in advertising activity of trust companies and various schemes were proposed to clients and their lawyers in order to circumvent the new tax. In April 1932, a lawyer wrote a letter to the New York Times complaining that now he was receiving circulars from “an old, solid and supposedly respectable institution” suggesting the use of trusts to “dodge” the new estate and gift tax. The lawyer was furious that at a time when “a distracted government” was trying to balance the budget, trust companies were still engaged in “an exhibition of gross and greedy selfishness which cannot but make the judicious grieve and the rash and heady ‘go bolshy’”. A number of other readers also deplored tax avoidance as “anti-social” behavior which would lead to social discord.204

In 1933 tax avoidance (often labeled “tax evasion” in non-professional discourse) became so visible that even the Church took up the issue. During a Senate investigation of the stock market crash, it was revealed that the chairman of the board of National City Bank of New York, Charles E. Mitchell, made huge paper losses on the sale of his bank’s stocks which he used to minimize his income tax payments for 1929.205 Following this discovery, various church officials called for businessmen to behave more ethically. “Tax evasion may be fair enough according to the law,” said an Oregon Bishop, but it is unethical. “The spirit of evasion is injurious to the spiritual health” of the nation,

204 Otto C. Wierum, Letters to the Editor: Urging Tax Evasion: The Ethics of Some Trust Companies are Questioned, N. Y. TIMES, April 1, 1932; I. Morris Wormser, Inheritance Tax Evasion, N. Y. TIMES, April 20, 1932; Curtiss Grove, Living Almost as Usual, N. Y. TIMES, June 17, 1932; D.F. Beckham, Our Peculiar Habits, N. Y. TIMES, June 30, 1933 (criticizing Americans for playing “the popular game of sticking Uncle Sam.”). But See Evasion before the Tax, N. Y. TIMES, April 10, 1932 (a reader arguing that “I have a right to avoid the incidence of the tax if it can be done legally”).
thundered a New York pastor, while another called it an “unchristian” practice and argued that “the poor man … naturally feels the injustice of allowing the rich to escape through jugglery advised by smart experts. This sense of injustice will upset the harmony that is necessary to bring back better days. The rich who dodge are sowing for a hurricane.”

Christian rhetoric was also used later by President Roosevelt when he criticized American lawyers and judges for condoning tax avoidance.

In the spring of 1935, the President finally started to exploit the huge symbolic capital of the issue in a deliberate and consistent manner (as Time magazine observed, “tax dodging tycoons are a juicy copy”). Roosevelt began a two-year long presidential campaign against tax avoidance by the “economic royalists”. The campaign culminated in the 1937 Revenue Act, an act explicitly directed at plugging various well-publicized (if economically insignificant) abuses of the tax code. This revived the moral dimension of tax avoidance discourse. Indeed, by 1937, Randolph Paul noted that “tax avoidance is an emotional subject” and that attitudes about it sometime reach a point of “hysterical

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205 Senator Wheeler Assails Mitchell, N. Y. TIMES, February 23, 1933

206 New Code for Financiers Urged by Bishop, N. Y. TIMES, March 3, 1933; Wealthy Evaders of Taxes Scored, N. Y. TIMES, March 26, 1933.

207 PAUL, TAXATION, supra note **, at 204. See also Martinez, supra note **, at 521 (discussing Catholic reaction to tax evasion in the 1940s).

208 Quoted in PAUL, TAXATION supra note **, at 206.

incoherence” and that “there is an echo of the Crusades in the fight against tax avoidance.”\textsuperscript{210}

The sustained presidential attack on the rich and their tax avoidance schemes naturally led to a defensive reaction in business circles, best summarized in J. P. Morgan’s famous observation that “taxation is a legal question...not a moral one” and that “congress should know how to levy taxes and if it doesn’t know how to collect them, then a man is a fool to pay the taxes.”\textsuperscript{211}

To sum up, tax avoidance, which was framed as a moral issue in early 20\textsuperscript{th} century discussions, was gradually shorn of its moral connotations in the professional literature of the 1920s and early 1930s. However, the economic pressures created by the Depression led some public actors such as the Church to reframe the issue as a moral question beginning in the last months of the Hoover administration in 1932.

One could argue that the change in judicial doctrines was a reaction to this process. The waning of moral censure of tax avoidance in the 1920s and 1930s led to a need to reinforce the feeling that tax payment was a duty of the citizens. As taxpayers and their advisers became more audacious in testing the boundaries of acceptable non-compliance, the courts were forced to introduce substantive tests.

\textsuperscript{210} Paul, Restatement, supra note **, at 74-75

\textsuperscript{211} Legal Tax-Dodging Upheld by Morgan, N. Y. TIMES, June 8, 1937. See generally, Paul, Taxation supra note **, at 203-4 (discussing Morgan’s utterance and public reaction to it); Leff, supra note **, at 195-200 (discussing the reactions to FDR’s attack on tax planning).
An additional incentive to changing judicial attitudes may have been provided by the tax revolts against local property taxes in the early 1930s. These revolts, by unorganized and organized taxpayers increased the fear of many Americans that the country was fast approaching economic and political chaos. One kind of reaction to the tax revolts of the early 1930s were national and local “pay your taxes” campaigns initiated by various interested parties to boost compliance at a time of great budgetary strains.\footnote{212 See generally, DAVID T. BEITO, TAXPAYERS IN REVOLT: TAX RESISTANCE DURING THE GREAT DEPRESSION (1989). See also Marjorie E. Kornhauser, Legitimacy and the Right of Revolution: The Role of Tax Protests and Anti-Tax Rhetoric in America, 50 BUFFALO L. REV. 819 (2002) (discussing current tax revolts and anti-tax rhetoric in the United States).} Perhaps one could argue that the shift in judicial attitudes in the early 1930s was another kind of “pay your taxes” campaign, less well-known but nevertheless representing the same kind of desire for social solidarity at a time of crisis.

The explanation which tries to account for \textit{Gregory} by reference to the ebb and flow of moral discourse on avoidance may seem convincing. However, such an explanation does not reflect the actual sentiments of the specific judges who decided \textit{Gregory}. The case itself contained no indication that the use of tax avoidance was considered immoral by the judges deciding it. In fact, Hand specifically stated in \textit{Gregory} that “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.”\footnote{213 \textit{Gregory v. Helvering}, 69 F 2d 809, 810 (2nd Cir. 1934).} In addition, I have already cited part of a memo written in a later case,
Chisholm, in which Augustus Hand, one of the three judges in Gregory, explicitly rejected the moral argument saying that “I suppose my associates will be sorry for what [former New York] Mayor [William Jay] Gaynor called my ‘inconspicuous morality’ and lack of faith in a higher law, but I can’t help it.” The judges of the Second Circuit seem to have accepted the professional distinction between illegitimate evasion and legitimate avoidance and were unwilling to use moral terminology to justify an anti-avoidance position.

II. The Political Context

To what extent is Robert Stevens’ explanation of the Duke of Westminster applicable to the history of Gregory? Can the specific history of anti-avoidance doctrines in the United States be explained by the ideology of the judges? Did conservative judges like Justice McReynolds adopt a formalist and pro-taxpayer stance because of their political views while Learned Hand’s (moderate) progressive ideology lead him to adopt an anti-taxpayer approach in Gregory? Arguing that political views can influence anti-avoidance


215 See GERALD GUNTHER, LEARNED HAND: THE MAN AND THE JUDGE, 190-269, 435 (1994); KATHRYN GRIFFITH, LEARNED HAND, IN THE REMARKABLE HANDS: AN AFFECTIONATE PORTRAIT 1 (Marcia Nelson ed. 1982); Irving Dilliard, Learned Hand: A Personal Appreciation, in THE SPIRIT OF LIBERTY, supra note **, at v, xii (discussing Hand’s politics). Hand’s political convictions underwent a process of gradual change. Thus in 1932 he voted for Hoover rather than F.D.R. (in 1936, 1940 and 1944 he voted for Roosevelt) and that despite his growing realization that the New Deal was inevitable, he criticized many of the New Deal programs, and adhered to many of the conservative economic notions of his class. Guntther, id., at 435, 437-41, 455. See also Edward A. Purcell Jr., Learned Hand: The Jurisprudential Trajectory of an Old Progressive, 43 BUFF. L. REV. 873 (1995) (discussing the gradual change in Hand’s political
adjudication is not novel. Here, for example, is a comment on developments in estate tax
case-law published in 1940:

by and large, lawyers and judges are apt to be advocates of the status quo …
until quite recently most of our federal judges were drawn from successful
practitioners. Success in the practice of law attracts wealthy clients and the
character of a lawyer’s convictions is apt to be shaped by the clients whose
interests he is engaged to uphold. It is not any reflection upon the integrity of
the federal judiciary to say that many judges were frankly hostile to the
philosophy behind the modern tax system … however, recent decisions were
more favorable to the estate tax and this appears to be a result of the radical
reconstruction in the personnel of the Court and the new justice are more or
less committed to a political creed closely akin to the social philosophy
underlying the tax.\footnote{216}

On the other hand, attributing judicial decisions merely to ideology is too easy.
\textit{Gregory} itself is an example of this, since the Supreme Court opinion which affirmed
Hand’s decision was written by Justice Sutherland, one of the most conservative Supreme

\footnote{216 Charles L. B. Lowndes, \textit{Tax Avoidance and the Federal Estate Tax} \textit{7 LAW \& CONTEMPORARY PROBS.} \text{309, 328, 330 (1940).}}
Court Justices at the time. The following sections outline the argument about the relationship between politics and anti-avoidance adjudication in some detail and also show the limits and ambiguity of the link.

1. The Depression

Tax avoidance was not a major political issue during the boom period of the 1920s. The federal government enjoyed a budget surplus and the Treasury, led by Andrew Mellon, was not keen to tackle the issue. Indeed, Mellon successfully lowered income tax rates, arguing that the best way to fight tax avoidance was to reduce taxation and thus reduce the incentive to avoid.217 Despite the lowering of rates, the basic progressive structure of income taxation was retained in order to defuse radical attacks on capital, but the law also contained major loopholes which would enable the wealthy to effectively reduce their tax burden.218

By 1929 the economy was slowing down and in late 1929 the stock market collapsed ushering in the Depression. It was a time of tremendous upheaval. Millions were destitute. Radical politicians were agitating for far-reaching redistributive measures to relieve the crisis. Revolution and anarchy were in the air. One result of the economic collapse was that the burden of taxation became insupportable. Between 1929 and 1932,

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217 *** MELLON, TAXATION AND THE PEOPLE. See also Smiley & Keehn, supra note **, at 287.

218 See Brownlee, Public Sector, supra note **, at 1033-34. It should be noted that while federal taxes decreased in the 1920s, state and local taxes increased dramatically. See BEIT, supra note **, at 1.
the combined federal and local tax burdens, measured as a percentage of the national income almost doubled, and local tax delinquency more than doubled.\(^{219}\)

In 1931 the budget surplus of the 1920s turned into a deficit. In March 1931, income tax receipts were 40% below those of the previous March while government expenditure grew. In May 1932, Congress enacted a revenue act which sought to raise rates.\(^{220}\) FDR’s administration came into power in March 1933. Roosevelt, who believed in the balanced budget, sought to finance his New Deal programs by finding additional sources of revenue.\(^{221}\) But imposing new tax burdens was out of the question. First, the economic hardship of the early years of the Depression meant that the country was constantly on the brink of a violent tax revolt.\(^{222}\) Second, in the first two years of his administration Roosevelt was wary of alienating the business community.\(^{223}\) One convenient way out of this dilemma was to adopt a tougher policy on tax evasion and avoidance by the wealthy.\(^{224}\)

Congress played an active role in the fight against evasion and avoidance. The Depression fueled popular resentment toward the rich, and many in Congress took note

\(^{219}\) See PAUL, TAXATION \textit{supra} note **, at 169-170; BETO, \textit{supra} note **, at 6-7.


\(^{221}\) Brownlee, \textit{supra} note **, at 1039-40. This interest was also the result of Roosevelt’s genuine belief in “progressive, ability-to-pay taxation.” See Ventry, \textit{Equity}, at 24, 33.

\(^{222}\) BETO, \textit{supra} note **; LEFF, \textit{supra} note **, at 14.

\(^{223}\) LEFF, \textit{supra} note **, at 15.
of this widespread “soak-the-rich” resentment. Furthermore, at hearings of the Senate Committee on Banking and Currency in 1932 and 1933 studying the stock market crash, it was revealed that the super-rich, far from suffering from the Depression, were in fact exploiting the new economic conditions to reduce their income tax burden. Thus, it became known that no partner in J. P. Morgan’s investment bank paid a cent in income tax in 1931 and 1932, because the losses they sustained on securities in 1929 were carried forward and used to write off whatever income they had in subsequent years. It was also uncovered that such losses were often paper losses created by the sale of stock to family members. Such revelations led, in June 1933, to the establishment of a Ways and Means subcommittee investigation on tax avoidance. The recommendations of the special subcommittee led in May 1934, two months after Gregory was decided to the enactment of the 1934 Revenue Act, intended to close some loopholes, including section 112(g) which was the subject of Gregory.

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224 Id.

225 Id., at 51, 68. See generally W. Elliot Brownlee, Economic History and the Analysis of ‘Soaking the Rich’ in 20th-Century America in TAX JUSTICE supra note **, at 71 (a history and analysis of the history of the “soak the rich” policy).

226 The bill was passed by the House in late February 1934 and was debated by the Senate in early March 1934, while Gregory was being decided. See Morgenthau Gives Tax Bill Approval, N. Y. TIMES, March 7, 1934. See also Ellen P. Aprill, Tax Shelters, Tax Law and Morality: Codifying Judicial Doctrines, 54 SMU L. REV. 9 (2001) (discussing the history of the 1934 act). See also LEFF, supra note **, at 59-67; PAUL, TAXATION, supra note **, at ¶ 11.01[2][a]; MCDANIEL, supra note **, at 548.
As time passed and the pressure from the Left on Roosevelt mounted, FDR’s interest in tax evasion and avoidance grew. In June 1935, Roosevelt renounced his previous reconciliatory policies toward business and turned tax reform into a major issue. His administration soon embarked on a campaign of its own against tax avoidance by the wealthy, revealing actual examples of wealthy individuals who had reduced their taxes considerably. This was intended to elicit popular anger and Congressional support for the fight against the “clever little schemes” of men of wealth and the 45,000 tax attorneys and accountants who were assisting them and, in the process, undermining “the decency of American morals.” FDR’s campaign caused a political storm but had little economic effect. It was followed by other anti-avoidance initiatives that led, in August 1937, to the enactment of the Revenue Act of 1937 which was specifically designed to deal with nine glaring loopholes on such matters as the incorporation of yachts and estates, thus epitomizing what historian Mark Leff called “the moralistic and political role of New Deal taxation.”

Tax avoidance and tax evasion thus played a major role in the politics of the 1930s. The issue was used by Congress and by the administration as a convenient scapegoat for the Depression. It cannot be doubted that the general political atmosphere and the role that the issue of tax evasion and avoidance played in American politics in the early 1930s

227 LEFF, supra note **, at 119-29, 135

were factors in the way Gregory was decided. However, much of the presidential campaign against tax avoidance post-dates Gregory. The general political history of New Deal tax avoidance rhetoric is not enough. One has to examine the minute day-to-day details of public discourse on the matter.

2. The Andrew Mellon Indictment

The general context in which Gregory was decided was one of economic pressures caused by the Depression, a changed political atmosphere following Roosevelt’s election, rising unemployment, alarming growth in local tax delinquency, organized tax revolts and counter-measures such as “pay your taxes” campaigns which reached a climax in late 1933 and early 1934. To this economic context one should add one specific event which, it can be argued, triggered the result in Gregory. This event is the curiously neglected story of the Andrew Mellon tax evasion trial, called by some the “tax trial of the century.”

Throughout the 1920s, there was some unease in political quarters about the fact that one of America’s richest men, the Secretary of the Treasury, was responsible for tax policy and tax administration. The inherent conflict of interest did not go unnoticed. It came to the surface as part of a battle fought in the mid-1920s between Mellon and Senator James Couzens of Detroit, a Republican millionaire. Couzens held much of his

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229 The history of the trial was recently discussed by Kirk Stark in an article about the tax decisions of Robert H. Jackson, who represented the Government in the trial. See Stark, supra note **. The trial is also briefly mentioned in BROWNLEE, FEDERAL TAXATION, supra note **, at 79 and discussed in BURTON HERSH, THE MELLON FAMILY: A FORTUNE IN HISTORY *** (1978).
wealth in tax exempt bonds. Mellon was opposed to the exemption given these bonds and in early 1924 he publicly attacked Couzens for holding his wealth is such bonds. In response, Couzens lobbied for the establishment of a special Senate investigation committee to study the practices of the Bureau of Internal Revenue (today’s IRS), including corruption in the Bureau and illegal favorable treatment of Mellon companies. The allegation was that Bureau officials had a “little black book” listing Mellon-owned companies and that officials who questioned the favorable treatment of these companies were transferred from their jobs or dismissed.

In response, the Bureau decided to examine Couzens’ 1919 tax returns and demanded that Couzens pay an additional $10,000,000 on the sale of Ford Motor Company stocks that he held. The Senate committee’s report, published in December 1925, revealed that Mellon companies enjoyed huge and unjustified tax benefits and tax refunds. Despite the troubling revelations, the report had little effect. Some Democrats,

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231 Mellon Defends Revenue Bureau, N. Y. TIMES, February 24, 1924; 796 Tax Officials Dropped for Graft, N. Y. TIMES, March 20, 1924; Mellon Offers Aid in Revenue Inquiry, N. Y. TIMES, March 25, 1924

232 O’Connor, supra note **, at 148-161.

233 Couzens Ignores Hugh Tax Claim, N. Y. TIMES, March 11, 1925; O’Connor, supra note **, at 144-5, 157-8.

234 Shows Big Refunds in Oil Firms’ Taxes, N. Y. TIMES, December 11, 1925; More Tax Losses Charged in Senate, N. Y. TIMES, December 15, 1925; Couzens Report Charges Tax Loss of $308,000,000, N. Y. TIMES, January 13, 1926
however, promised to look “into Uncle Andy’s books” once they came into power.\textsuperscript{235} The opportunity to do so arose in 1933.\textsuperscript{236}

In the early months of February 1933, David A. Olson, a former investigator for the Banking Committee which was investigating the crash of 1929, filed a $220,000,000 informer-action against Mellon charging him with assisting foreign steamship companies to evade taxation.\textsuperscript{237} In March 1933, Olson filed another suit alleging tax avoidance by officials of the Gulf Oil Corporation, including Mellon.\textsuperscript{238} During the same period, a Senate investigation of the stock market crash revealed that the Chairman of the Board of the National City Bank of New York, Charles E. Mitchell, showed huge paper losses on the sale of his bank’s stocks which he used to minimize his income tax payments for 1929. Mitchell was put on trial in May 1933.\textsuperscript{239}

FDR was sworn in on March 4, 1933. Mellon, who was serving as the American ambassador to Britain, returned to the United States in the same month. This was not the best time to return. Populist Senator Huey Long was now in New York, castigating his

\textsuperscript{235} O’Connor, \textit{supra} note **, at 148, 160.

\textsuperscript{236} \textit{See Mellon Attacks Cummings on Suit}, N. Y. TIMES, May 5, 1934 (Mellon alleging that he received a warning “more than a year ago from a source high in the councils of the Democratic party … that a definite effort was being made to discredit me in connection with either my administration of the treasury or my tax affairs.”)

\textsuperscript{237} \textit{Mellon is Named in $220,000,000 Suit}, N. Y. TIMES, February 28, 1933. Olson hoped to collect part of the amount due as an informer. \textit{See, Mellon Bands Tax Suit Politics’}, N. Y. TIMES, March 12, 1934.

\textsuperscript{238} \textit{Sues Gulf Oil Officials}, N. Y. TIMES, March 14, 1933.

\textsuperscript{239} \textit{Mitchell on Trial as Tax Dodger Today}, N. Y. TIMES, May 11, 1933. Mitchell was acquitted in June 1933. \textit{See, Mitchell Cleared, Weeps at Verdict, Ovation in Court}, N. Y. TIMES, June 23, 1933.
fellow Americans for going after small fry like Mitchell. The question, said Long, was whether Americans were willing to confront the real lions, the men who “control America” - Morgan, Rockefeller, and Mellon.\textsuperscript{240} By the end of March 1933, there were calls in the Senate to investigate the Olson allegations.\textsuperscript{241}

In May 1933, resolutions were submitted to the Senate and the House calling for an investigation of the Olson charges as well as charges that Mellon had unlawfully reduced his personal income tax return for 1931 by creating artificial losses. Following the Senate proceedings, the new Attorney General, Homer Cummings, promised to investigate both the personal charges and charges relating to steamship companies tax refunds.\textsuperscript{242} One of the charges involved the use of corporate reorganization provisions to avoid taxation. The investigation was carried out in the summer and fall of 1933.\textsuperscript{243}

During the summer of 1933, the newspapers contained numerous reports of allegations of improper tax behavior by Mellon and his relatives, and by companies related to him and to other prominent financial and political figures.\textsuperscript{244} Meanwhile, a best-

\textsuperscript{240} Huey Long Offers Cure for our Ills, N. Y. TIMES, March 26, 1933
\textsuperscript{241} Calls for Inquiry in Ship Tax Case, N. Y. TIMES, March 28, 1933
\textsuperscript{242} Mellon’s 1931 Tax to be Investigated, N. Y. TIMES, May 12, 1933
\textsuperscript{243} Mellon Tax Inquiry Begun by Cummings, N. Y. TIMES, June 16, 1933; Hersh, THE MELLON FAMILY, 316-17, 321.
\textsuperscript{244} See, e.g., Mellon Tax Data asked in Senate, N. Y. TIMES, May 30, 1933; Senators to Delve into Morgan Tax, N. Y. TIMES, June 7, 1933 (reporting a proposed Senate investigation of the tax returns of the partners in the banking firm of J.P. Morgan); W.L. Mellon Sued as a Tax Evaser, N. Y. TIMES, June 15, 1933 (charges of tax evasion against William L. Mellon, Mellon’s nephew); Mellon Interests Bargain on Taxes, N. Y. TIMES, July 13, 1933 (reporting a local property tax compromise offer by a Mellon-related company); Walker’s Income is under Inquiry, N. Y. TIMES, August 17, 1933; Walker Income Tax Inquiry is Dropped, N. Y.
selling muckraking biography of Mellon, written by a radical journalist, Harvey O’Connor, appeared.245 O’Connor also published a popular version of his book in a pamphlet called “How Mellon Got Rich.”246 In the book and the pamphlet O’Connor argued that Mellon used his position as Secretary of the Treasury to substantially increase his wealth, using tax cuts and tax refunds to benefit himself and his fellow capitalists.247 O’Connor’s book revived the allegations contained in the report of the special Senate committee on the Bureau of Internal Revenue published in 1926. In the book, O’Connor challenged the Democrats who had promised in the 1920s to inspect “Uncle Andy’s books.” Their threats proved idle, he insinuated, perhaps because such an investigation would disclose that wealthy Democrats were also “beneficiaries under the Mellon regime.”248

The fall of 1933 saw official reaction to this wave of allegations. New administrative procedures were put in place by the Bureau of Internal Revenue.249 Criminal prosecutions for tax fraud also intensified.250 The Bureau’s policy to compromise with taxpayers rather

245 O’Connor, supra note **.
246 HARVEY O’CONNOR, HOW MELLON GOT RICH (1933).
247 Id., at 17-18.
248 O’CONNOR, MELLON’S MILLIONS, at 160-1.
249 Wall Street to be Combed for Tax Evaders, N. Y. TIMES, October 17, 1933; Evasion of Taxes Hit by New Rules, N. Y. TIMES, January 21, 1934 (reporting new regulations requiring brokers to report of profits and losses of certain stock trades).
250 1,444 Fraud Cases on Federal Taxes, N. Y. TIMES, January 9, 1934
than litigate cases was called into question. 251 Meanwhile, a Congressional committee submitted a report proposing various changes which would reduce tax avoidance. 252 The result of the recommendations, a “loophole-plugging” tax bill, which was passed by the House in February 1934 and debated by the Senate in the first week of March, exactly when Gregory was being decided by the Second Circuit. 253 Even the President, who was playing only a secondary role in the campaign against tax evasion at the time, added a rhetorical contribution to the debate by denouncing, in early January 1934, the “high officials of banks and corporations” and “individuals who have evaded the spirit and the purpose of our tax laws.” 254 But perhaps the most pertinent development was the creation, in December 30, 1933, of a new tax division in the Department of Justice whose task was to coordinate more effectively the campaign against tax evasion. 255

The case against Mellon would be the first major case of the new division. In late January and early February 1934, Attorney General Cummings mentioned that a decision about prosecuting Mellon for tax evasion would soon be reached. 256 He also announced that he had ordered a monopoly investigation of the Mellon-dominated Aluminum
Company of America.\(^{257}\) On March 10, 1934, six days before the judges of the second circuit finally decided *Gregory*, Cummings announced that he was asking for a Grand Jury study of alleged tax evasion by Mellon and three other prominent individuals: the former Mayor of New York, a leading banker and a lawyer.\(^{258}\) In the next four days, the grand jury inquest dominated the headlines. On March 12, Mellon counter-attacked, calling the action of the Attorney General “politics of the crudest sort.”\(^{259}\) Some Republicans joined the battle hoping to exploit the scandal as a rallying cry for a revival of the fortunes of the Republican party.\(^{260}\)

All these events were taking place as the Second Circuit was deciding *Gregory*. The brief for the petitioner was filed on January 16, 1934. The brief for the respondent was filed on February 20, 1934. As was their habit, the judges of the Second Circuit wrote and circulated pre-conference memoranda before deciding the case.\(^{261}\) In his memorandum of February 27, 1934, Hand suggested that the decision of the Board of Tax Appeals be


\(^{260}\) *Fight on New Deal Begun, Mason Says*, N. Y. TIMES, March 14, 1934; *In Washington: Roosevelt Reported to Be in Dark on Mellon Tax Suit*, N. Y. TIMES, March 14, 1934

reversed. The memos of the two other judges are not dated. Augustus Hand also voted to reverse but Judge Swan wanted to affirm the decision of the Board of Tax Appeals based on the argument that there is a distinction between tax avoidance and tax evasion and that the court should not intervene in cases of avoidance. The Hands convinced Swan to change his position and Learned Hand wrote his opinion in the two and a half weeks between February 27, 1934 and March 16, 1934 (the date on which the typewritten copy of Hand’s decision was signed by the other two judges). During those two and a half weeks, the Mellon affair was a major news item.

Subsequent events are less relevant to Gregory. It would suffice to mention that in May 1934, a Pittsburgh grand jury which was asked to indict Mellon for failing to pay nearly $2,000,000 in taxes in 1931 refused to indict him. Mellon, however, was not satisfied with the result and decided to clear his name by seeking a tax refund of about $140,000 for the year 1931. He filed a petition to that effect with the Board of Tax Appeals. Robert H. Jackson, then the Chief Counsel of the Bureau of Internal Revenue, who represented the Government, retorted by arguing that in fact Mellon owed more than $3,000,000 and repeating the allegations of fraud previously made against Mellon, arguing that in his capacity as Secretary of the Treasury he became “especially skilled” in

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263 U.S. National Archive file.
264 Mellon is Cleared of 1931 Tax Evasion, N. Y. TIMES, May 9, 1934.
265 Mellon Hits Back: Asks a Tax Refund, N. Y. TIMES, May 26, 1934
matters of tax avoidance and that he used this knowledge to lay out his own tax
avoidance schemes.\textsuperscript{266} During the hearings it was revealed that Mellon, while Secretary of
the Treasury, solicited a memorandum on tax avoidance and later used five of the ten
devices listed in the memorandum to reduce his taxes, surely an ethically unacceptable
behavior.\textsuperscript{267}

To sum up this section, in the months and weeks before Judge Hand decided \textit{Gregory},
front page news contained reports accusing the former Secretary of Treasury of tax
evasion and tax avoidance. It seems reasonable to speculate that these reports had some
effect on Hand’s attitude to the issue. But one can also provide more direct evidence.

3. The \textit{Webb v. Commissioner} and \textit{Taylor v. Commissioner} Memos

The evidence presented to this point is circumstantial. There is no direct utterance by
Hand which proves that political considerations led him to adopt a substantive anti-
taxpayer position in \textit{Gregory}. It is of course often immensely difficult to prove what
actually motivates judges to decide the way they do. Their decisions are often not helpful
because their arguments are elaborate screens designed to hide their real motives. Still, at
least in the case of Hand, we do have access to his more personal thoughts in the form of

\textsuperscript{266} Tax Bureau Says Mellon Used Treasury Experience in Avoiding Income Levies, N. Y. Times, September 16, 1934

\textsuperscript{267} See Blum, supra note **, at 324-6.
memos that he and his colleagues on the Second Circuit wrote. Some these memos provide an uncensored window to Hand’s thoughts.

Hand’s memo in *Gregory* is not very helpful. It contained no indication that the political context had an effect on the decision. The memo was a legal analysis of the case at hand. Hand stated that “I refuse to read this section [the reorganization provision] with a dictionary in one hand, closing my eyes to the obvious purpose which suffuses the words chosen,” but there was no explicit indication in the memo that Hand was influenced by any non-legal considerations. Hand based his approach on two recent cases dealing with the continuity of proprietary interest in reorganizations.²⁶⁸ The only policy-like argument in the memos on the case comes from Judge Swan, who, in the pre-conference memo stage, favored affirming the decision of the Board of Tax Appeals, and wrote that “I don’t know where it will lead us to hold that a corporation may be disregarded if its purpose was to minimize taxes.”²⁶⁹ However, there is some indirect evidence that perhaps non-legal factors had some influence on the way Hand decided

²⁶⁸ These were *Pinellas Ice & Cold Storage Co. v. Commissioner*, 287 U.S. 462 (1933) and *Cortland Specialty Co. v. Commissioner*, 60 F. 2d 937 (2d cir., 1934). In both cases a corporation transferred most of its assets to another corporation in return for cash and short-term promissory notes. It was then claimed that this was a tax-free reorganization and not a taxable sale. However, the courts in both cases decided that since the taxpayer corporation which transferred its assets received no stock or securities in the purchasing company, this could not be considered a reorganization. Hand saw both cases as “pertinent, if not authoritative” *Gregory*, p. 811. Mrs. Gregory argued that the two cases could be distinguished since they dealt with a different statutory provision than the one discussed in *Gregory*. See Brief for the Respondent, Helvering v. Gregory, U.S. Court of Appeals, Second Circuit, Case no 13158 (filed 20 February 1934), pp. 25-6, 34, 37.

Two tax cases decided in the months immediately before and after *Gregory* provide a glimpse of Hand’s sentiments.

The first case, *Webb v. Commissioner*, was decided in December 1933, three months before the decision in *Gregory*. Mrs. William Seward Webb, Jr. was the daughter of the former Mayor of New York and was married to the great-grandson of Cornelius Vanderbilt. She was also a neighbor, friend and distant relative of Harry Payne Whitney, one of America’s wealthiest men, a celebrated polo player and racehorse owner.270 One day in 1919, in Bradley’s Place in Palm Beach, Mr. Whitney saw Mrs. Webb playing roulette with 50-cent chips. He said to her, “that is a foolish way to try to make money. I can make some real money for you” by trading in stocks. When Mrs. Webb replied that she could not buy stocks, Mr. Whitney told her that he would open a brokerage account in her name. The account was promptly opened. Instructions to the brokers were given by Mr. Whitney, but he occasionally “confer[ed] with Mrs. Webb in a jesting manner about buying or selling stocks for her account and she would tell him to do whatever he wished.” In 1925, the account showed a profit of $70,000. The simple factual question decided in this case was whether Mrs. Webb was the owner of the account and thus liable

270 See *H.R. Whitney Dies at 58*, N. Y. TIMES, October 27, 1930; *Put into Market; Got $72,000 Profit*, N. Y. TIMES, December 12, 1933; *Mrs. Seward Webb Dead in Vermont*, N. Y. TIMES, July 11, 1936.
to pay taxes on the profits that were accumulated in it and Judge Swan, who wrote the opinion in this case said that she was.\textsuperscript{271}

Hand was one of the judges on the panel and the facts of this case excited him. In the first paragraph of his memo, he commented on the life style of Mrs. Webb and her friends. “Boys”, he said (addressing his fellow judges),

\begin{quote}
this is a very important case, but not in the way you think. It is important because we three worms are never again going to get in touch with such high society. Remember that in all we say or do, and be humble and respectful to the persons concerned. Talk about it to your friends; you may get asked to dinner because you are dealing with the affairs of such extremely important high persons. Think of it, just ordinary slobs like judges to be allowed to have anything to say about transactions at Bradley’s Palm Beach! and fifty-cent chips at roulette! Gosh! I feel better for having been on the bench.\textsuperscript{272}
\end{quote}

Hand then forced himself to comment on the case: “Coming down to the gross details, I fear that this high-roller has got to contribute his mite to sustain the falling dollar.”\textsuperscript{273} But

\textsuperscript{271} See Webb v. Commissioner, 67 F.2d 859 (2d cir. 1934). See also Put into Market, Got $72,000 Profit, N. Y. TIMES, December 12, 1933.

\textsuperscript{272} Hand Papers, File 194-4. Dated November 15, 1933.

\textsuperscript{273} \textit{Id.}
he could not resist ending his memo with another remark about the persons involved in the case,

there is not the slightest evidence that Whitney supposed that if there were a profit, he might use his discretion to take it as his own. And really, fellows, Payne was not that sort of man. I once knew someone who saw him at the race track, and Payne was the finest kind of sportsman in America. True blue was Payne, fellows; he never would have served the ‘girls’ [Mrs. Webb and her friends] such a scurvy trick. Really, Payne was, - -- well, all I can say, fellows, is that Payne was Payne, if you know what I mean.274

It is possible that when Hand was writing this memo, he simply wanted to have some fun.275 Perhaps he just relished the possibility of a sarcastic reference to Payne-Whitney’s family’s name. However, this memo may have reflected deeper feelings. Perhaps it had its roots in the social rejection that Hand had suffered as a young college student at Harvard. Gerald Gunther, Hand’s biographer, recounts that when Hand arrived at Harvard in 1889, he felt like an “outsider”, “untamed native” or a “frank barbarian from a small New York town.”276 Harvard at the time was a deeply stratified,
snobbish place where social standing was everything and Hand, despite being from a respectable Albany family, was no match for the sons of the best Boston and New York families. Hand strove for social approval and participated in the rigid, formal processes of club-selection at Harvard but his attempts to become a member of Harvard elite social clubs ended in a miserable failure. This failure, said Gunther, “left scars that would never heal.”

Perhaps Hand’s memo in *Webb* reflected these deep scars.

A month after *Gregory* was decided, another tax case came before Hand, *Taylor v. Commissioner*. Walter W. Taylor was a prominent New York investor and society figure. This case involved the technical question of calculating the basis of gains he made on some preferred shares in a holding company he owned. In 1927, Taylor bought shares of four small lighting companies in Vermont through a holding company. A year later his holding company sold the shares of the four companies for twice the amount that was paid for them. Taylor then retired his preferred shares in the holding company and received a certain sum and the question arose as to what the basis for calculating taxable gain on these preferred shares was. This was a factual question and Hand accepted the taxpayer’s arguments and held that the method of calculation chosen by the Board of Tax Appeals in this specific case was unreasonable.

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277 *Id.*, at 26-9.
278 70 F. 2d 519
279 See, e.g., *Walter W. Taylor Sr.*, *N. Y. Times*, March 29, 1951; *Social Activities in New York and elsewhere*, *N. Y. Times*, October 21, 1941
However, Hand opened his memo with the following words: “I rather dislike to let off this high financier, but I don’t quite see how we can help it.” Later in his memo he described Taylor’s four companies as “bought up merely to put off on suckers in the bad old days when they were being born at a much greater rate than one a minute.” Clearly, Hand harbored some dislike of the unscrupulous wealthy and their methods of getting rich and one might also suspect that he would be willing, when given the opportunity (for example if purposive interpretation allowed it) to disregard their tax avoidance schemes, as was the case in Gregory.

While one cannot provide hard evidence to prove that Hand’s dislike of “high financiers” or of “high society” played a direct part in his decision in Gregory, this does not mean that these factors did not play a part. My claim is not that judges consciously base their decisions on their political ideology or sentiments. Instead, the argument is that there is a “half conscious” and repressed impact of political views and inclinations on how judges decide cases, and that the only way to show this is by using interpretative contextualist methodology which is not meant to provide hard evidence. As Jerome Frank, one of the leading legal realists who later served as Hand’s colleague on the Second Circuit bench, said in 1937 when he was discussing tax avoidance doctrines,

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281 See generally, KENNEDY, CRITIQUE, supra note **, at 54-6 (arguing that it is often impossible to supply “direct” or “hard” proof that judges consciously shape their decisions based on their politics and ideology and that instead the impact of ideology is “half-conscious”).
“there are a multitude of cases (such as … tax avoidance … cases) where non-rational factors, not discoverable by anyone, the judge included, vitally affect decisions.”

CONCLUSION

In the end, what influenced the decision? Was Robert Stevens right about the impact of politics on tax avoidance adjudication? Was the class-based explanation that Stevens offered when discussing the British Duke of Westminster case applicable to American law? Perhaps the answer is less clear than one would like it to be. While the story I told does gives some indication that political views and class-sentiments may have played some role in the history of tax avoidance adjudication, it seems that Gregory should be understood not as the product of a single factor but as a product of a number of different factors.

First, the decision was certainly effected by the general climate of legal change; that is, by the rise of a “realist” conception of law and interpretation and, more specifically, by the rise of a less formalist and less tolerant attitude toward tax avoidance whose origins are to be found in many early 1930s decisions.

Second, the decision (as well as the general anti-formalist legal climate itself) were the result of the pressures of the Depression, a period of extreme economic hardship, budgetary crisis, tax revolts and various tax related scandals, all of which led to a less

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tolerant public attitude to tax avoidance and to a renewed emphasis in public discourse and public cultural perceptions on the immorality of the practice.

Third, the case was a product of the specific ideological inclinations of Judge Hand, the result of his general progressive outlook and perhaps also of the instinctive resentment he felt toward the more successful and ruthless members of his class. But the case was not merely the result of long-term ideological outlooks. It was also the result of contingent events like the Mellon affair.

Stevens’ insight about the impact of politics on tax avoidance and tax interpretation doctrines thus appears to be partly correct. Ideology and class-sentiments did play some part in shaping the substantive approach in *Gregory* just as they influenced the formalism of the British *Duke of Westminster* case, and just as the formalism of the *Duke* case can be understood as the result of a desire to shield the British upper classes from the impact of re-distributive taxation, so the anti-formalism of *Gregory* may have been the result of psychologically based antagonism to the tax tricks of “high financiers”. However, Stevens is not completely right in the sense that the story cannot really be reduced to one factor. Instead of a mono-causal politically-based approach to explaining the case, it seems better to adopt an eclectic approach which views developments in tax law adjudication as generated by a number of factors: legal, economic, psychological, cultural and political - both long term ideological trends as well as short term fluctuations in public-opinion based on contingent events (such as the Mellon indictment in our case).
Why is this story important? First, in recent years the judicial treatment of tax avoidance has again become a major concern of tax administrators, lawyers and scholars as part of the wider debate about the proper way to deal with the problem of corporate tax shelters.\textsuperscript{283} As was to be expected, the current resurgence of interest in the subject bears uncanny resemblance to previous occasions. Thus for example the current economic crisis and budget deficit together with the precarious security situation have led some observers to characterize corporate tax shelters as “unpatriotic.”\textsuperscript{284} However, recent scholarship on the problem tends to view anti-avoidance doctrines in an a-historic and a-political way. For example, some discussions of judicial anti-avoidance doctrines repeat previous attempts to reconcile contradictions in the cases and create a kind of “unified theory of tax avoidance doctrines” without showing an awareness of the fact that the cases cannot really be reconciled because history proves that they are shaped by contingent non-legal forces.\textsuperscript{285}

Another problem is that while there is an awareness among some tax scholars of the importance of using the “lessons of history” when studying the problem of corporate tax shelters, little attempt is made to study the these “lessons” as historians do, that is by

\textsuperscript{283} See, e.g., cites in note **. [U.S. Dept. of Treasury etc.] For earlier surges in interest See, e.g., Cooper, supra note **.

\textsuperscript{284} See David Teather, \textit{Corporate America, Come Home!}, THE GUARDIAN, February 28, 2003 (describing shareholders demands for an end to off-shore registration and finding the roots of this demand in shady accounting practices in places like Bermuda but also in the post-September 11 security and economic environment which has lead to increased concern with tax avoidance and to the view that avoidance is unpatriotic).

\textsuperscript{285} See, e.g., The Problem of Corporate Tax Shelters, supra note **, at 46-58.
examining the problem in a contextual way which takes into account various non-legal factors. A better understanding the non-legal factors that shape and limit judicial intervention in tax avoidance cases would lead to a more realistic and informed debate about the possible role of courts in the fight against corporate (as well as individual) tax shelters. Thus the fact that even leading judges like Learned Hand seemed to have approached the issue of tax avoidance in an inconsistent manner, varying the scope of their intervention based on contingent events and public moods, makes one place far less hope in the ability of the courts and their anti-avoidance doctrines to lead the battle against corporate shelters.

An awareness of history would also lead, perhaps, to increased attention to the role of public opinion in fighting avoidance. It is interesting to note that while recent discussions of the subject suggest and analyze a large number of legal methods for fighting avoidance (such as increasing penalty rates, instituting disclosure requirements, codifying the common-law anti-avoidance doctrines), none of the recent works on the

286 See George K. Yin Getting Serious About Corporate Tax Shelters: Taking a Lesson from History 54 SMU L. REV 209 (2001) (discussing the shelters in the 1970s and 1980s); Eustice, supra note ** (containing anecdotal history of tax shelter activity in the 1950s). See also Cooper, supra note **, at 664 (noting that the problems associated with avoidance keep returning to haunt us since the early 20th century); Hanna, Business Purpose, supra note **, at 7 (noting that “some of the most high profile issues in the U.S. tax system today, such as the applicability of the substance versus form, business purpose and economic substance doctrines, are the exact same issues that the government, courts and commentators struggled with years ago”); Schler, supra note **, at 395 (admitting that “the issues concerning tax shelters have not really changed since the debate among the judges that considered Gregory v. Helvering”). For discussions of the problem that do take into account the experience of the 1930s see, e.g., Aprill, supra note **; Steven A. Bank, Codifying Judicial Doctrines: No Cure for Rules But More Rules, 54 SMU L. REV. 37 (2001).

287 Bankman, The New Market, supra note **, at 1785-94; Schler, supra note **, at 361-84.
subject mentions the possibility of using public opinion as a weapon in the battle against avoidance, a point which was so obvious to FDR and to the Treasury of the 1930s.

Recent discussions of tax compliance have highlighted the importance of social norms in creating and maintaining compliance. Thus Eric Posner has recently suggested that people pay taxes not because they fear penalties but because tax compliance serves as a signal to other people in the community that the taxpayer is a “good guy.” There are obvious differences between individual and corporate compliance, evasion and avoidance, but the common-sense intuitions that underlie Posner’s approach seem applicable to the problems of corporate tax shelters. The history of *Gregory* told in this article also reinforces the argument implied in Posner’s work about the central role that social norms and public opinion play in achieving compliance.

Second, the story of *Gregory* is important not just for the practical lessons that it may or may not hold but also as an antidote to any rigid use of social-science theories to understand tax law; both class-based interpretations and abstract economic models are reductive. A micro-examination of *Gregory* shows that such approaches cannot, alone, account for changes in tax law. History is one empirical ground in which social-sciences models can be tested and complemented. The role of history in this case is to provide a

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289 See Bankman, *The New Market*, supra note **, at 1784 (for anecdotal evidence about the effect of social norms on corporate executives who refrain from using tax shelters).
complex multi-factor explanation, enriching the simple and reductive approaches favored by the social science disciplines.

Third, the story of Gregory is important as part of a more comprehensive jurisprudential attempt to understand how judges decide cases in general and tax cases in particular. I ended the last section with a quote from Jerome Frank on the factors that really shape tax avoidance decisions. Perhaps it is now useful to invoke the words of Frank’s intellectual forefather, Oliver Wendell Holmes, who seems to have reached the same conclusion about the eclectic, contingent nature of judicial law making in his famous saying according to which “the felt necessities of the time, the prevalent moral and political theories, intuitions of public policy, avowed or unconscious, even the prejudices which judges share with their fellow-men, have had a good deal more to do than the syllogism in determining the rules by which men should be governed.” More than a hundred and twenty years after Holmes wrote these words, they are still relevant for those interested in understanding tax avoidance adjudication. For if the story of the duke and the lady teaches us anything, it teaches us that only by being aware of and taking into account many factors - legal, cultural, economic, political and psychological - can we really begin to understand how tax avoidance cases are decided.