

FAIRNESS AND LEGALITY IN INCOME TAXATION:
GLOBAL TAX SHELTERS, LEGAL PRAGMATISM, AND THE ETHICS OF INTERPRETATION

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I. INTRODUCTION

Western economies continue to prosper.¹ An ever-accumulating knowledge base supports amazing advances in robotics, bio-technology, and computing capabilities.² These advances generate widespread growth in both labor productivity and real-per-capita-GDP.³ Unfortunately, these same technologies also contribute to a growing polarization of wealth.⁴ The financial gains from technology tend to accrue to those who hold the intellectual property rights.⁵ In addition, robotics and computer capabilities reduce demand for unskilled labor while bio-technology creates new markets for expensive life-extending services. Both the reduction in labor demand and the new, technology-enabled markets tend to transfer income from wage-earners to the owners of technology.⁶ As a result, in most developed economies today, productivity and GDP growth are not the primary economic concerns.⁷ The primary economic concerns reside in the polarization of wealth and income between social classes.⁸

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¹ The notion of "prosperity" is open to interpretation. Many western economies are awash in debt. Yet, for every debtor one finds a creditor, and much of the debt is owed domestically or to people in other western nations. Hence, the fears of a financial crisis of debt can be misleading. Prosperity is better measured in real terms, not nominal. In real terms, measured by per-capita production of real goods and services (GDP), the world has never been more prosperous. See The World Bank, *GDP per capita (current US\$)*, <http://data.worldbank.org/indicator/NY.GDP.PCAP.CD/countries> (last visited Feb. 16, 2015) (documenting a steady upward trend in real-GDP-per-capita from 1995 to 2014 in virtually all western economies) [hereinafter World Bank, *GDP data*].

² This accumulating knowledge base has a central location, namely, the worldwide collection of patent applications. While patent law grants monopoly privileges, it also encourages the disclosure of ideas through the application process. These applications provide a storehouse of knowledge that others can inspect and build upon by adding their own novel insights. See generally ROGER E. SCHECHTER & JOHN R. THOMAS, *INTELLECTUAL PROPERTY: THE LAW OF COPYRIGHTS, PATENTS, AND TRADEMARKS* 7-9 (2003) (discussing policy justifications for the patent system).

³ See World Bank, *GDP Data*, *supra* note 1 (documenting growth in real-per-capita-GDP); The World Bank, *GDP per person employed (constant 1990 PPP \$)*, <http://data.worldbank.org/indicator/SL.GDP.PCAP.EM.KD/countries> (last visited Feb. 16, 2015) (providing worldwide data on productivity growth). See generally WENDELL GORDON & JOHN ADAMS, *ECONOMICS AS SOCIAL SCIENCE: AN EVOLUTIONARY APPROACH* 7-13 (1989) (discussing how the accumulation of technical knowledge generates productivity gains and economic growth).

⁴ See Robert B. REICH, *AFTERSHOCK: THE NEXT ECONOMY AND AMERICA'S FUTURE* 44-45 (2011).

⁵ See *id.* at 45.

⁶ See *id.*

⁷ See generally JOSEPH E. STIGLITZ, *THE PRICE OF INEQUALITY: HOW TODAY'S DIVIDED SOCIETY ENDANGERS OUR FUTURE* (2012) (identifying income inequality as the primary economic threat facing America); TIMOTHY NOAH, *THE GREAT DIVERGENCE: AMERICA'S GROWING INEQUALITY CRISIS AND WHAT WE CAN DO ABOUT IT* (2013) (same).

⁸ The recent "Occupy America" movement focused public awareness on distributional issues. See generally TODD GITLIN, *OCCUPY NATION: THE ROOTS, THE SPIRIT, AND THE PROMISE OF OCCUPY WALL STREET* (2012) (discussing the recent social movement); LISA A. KEISTER, *WEALTH IN AMERICA: TRENDS IN WEALTH INEQUALITY* (2000) (discussing the root causes of wealth polarization). In 1976, the top 1% of U.S. income-earners earned 8.9% of total income; in 2007 it was 23.5% while at same time average-real-hourly-wage declined by 7%. See Robert H. Frank, *Income Inequality: Too Big to Ignore*, N.Y. TIMES, Oct. 16, 2010. President Obama highlighted his concerns with

A progressive tax system provides a direct means for addressing the concerns posed by economic prosperity combined with maldistribution of wealth.⁹ Scandinavian countries, for example, which are among the most prosperous in the world, have traditionally used their income tax systems to great effect.¹⁰ In Scandinavia, tax revenues support universal health coverage, free public schooling, and supplemental retirement income.¹¹ The same is true in most of Western Europe and, to a lesser extent, in the United States. Worldwide trends, however, suggest that the economic policies of tax and transfer have come under siege as multinational corporations and wealthy individuals increasingly shift their income to international tax havens and use various forms of tax shelters to avoid paying income taxes.¹² Without a progressively fair and effective sharing of tax burdens, technological imperatives and other market factors will continue to polarize wealth and generate political tensions.

This article examines economic, jurisprudential, and ethical issues posed by global tax shelters. The analysis proceeds in three parts followed by a conclusion. Part II provides a taxpayer's perspective. It discusses the economic lure of tax shelters and outlines some basic tax-avoidance strategies, including the construction of potentially abusive step transactions and the use of international tax havens.¹³ Part II also explores whether it is ethical to use such strategies. The discussion draws on recent OECD directives regarding the social obligation to cooperate with taxing authorities and considers the role of professionals who advise on such matters.¹⁴

Part III shifts the focus to the judiciary. It begins by reviewing several anti-tax-avoidance doctrines developed by U.S. courts, including "substance-over-form" and the "business purpose" test.¹⁵ These doctrines invite courts to close legal loopholes and to denounce overly-aggressive tax strategies as criminal tax evasions. The discussion highlights the critical role played by legal philosophy. It compares and contrasts a jurisprudence of positive-legal formalism, or legalism, which limits the use of anti-tax-avoidance doctrines, with a more pragmatic jurisprudence which encourages their use. The analysis demonstrates that given the current trends in tax avoidance and the needs of western economies, the more pragmatic jurisprudence is preferred.

Part IV offers a case study drawn from the global community. In particular, it examines a tax controversy currently working its way through Swedish courts. The controversy involves the application of a "true business purpose" test to intra-group loans to establish whether interest payments on such loans are deductible from the debtor's taxable profit. Embracing the Swedish tradition of literal interpretation, taxpayer advocates seek to limit the use of a true business purpose test, while policy-oriented proponents of the test contend that an active use of the rule could help eliminate unintended and unfair tax shelters. The controversy highlights the tension between formal fairness and material fairness that resides at the core of this article. The Swedish courts must decide whether a pragmatic jurisprudence that requires them to play an active role in the formation of public policy can incorporate an appeal to material fairness without unduly harming a commitment to formal fairness that promises to safeguard the rule of law. The case study helps fix the ideas presented in the first parts of the article.

maldistribution in the 2015 State of the Union Address. See Barak Obama, *Remarks by the President on the State of the Union*, Jan. 21, 2015, available at <http://wbay.com/2015/01/21/complete-text-state-of-the-union-address> (last visited Feb. 16, 2015).

⁹ See THOMAS PIKETTY, *CAPITAL IN THE TWENTY-FIRST CENTURY* (2014) (arguing that the rate of return on capital typically exceeds the rate of economic growth thereby accelerating income inequality between social classes and proposing a global system of progressive taxes to address the issue); Robert B. Reich, *Testimony before the Joint Economic Committee, United States Congress*, Jan. 16, 2014, available at http://www.jec.senate.gov/republicans/public/?a=Files.Serve&File_id=121e5a80-61e2-4c65-aa25-a06a1c0887d5 (proposing more progressivity in the income tax system as a direct means to reduce inequality).

¹⁰ In 2013, Norway ranked second, Sweden ranked seventh, and Denmark eighth worldwide in real-per-capita-GDP. See World Bank GDP data, *supra* note 1.

¹¹ Denmark, Norway, and Sweden have been ranked as the three most law-abiding nations in the world. See The World Justice Project, *Rule of Law Index 2014*, at 174, available at http://worldjusticeproject.org/sites/default/files/files/wjp_rule_of_law_index_2014_report.pdf, (last visited Feb. 16, 2015). The respect for the rule of law gives economic advantages.

¹² See generally NICHOLAS SHAXSON, *TREASURE ISLANDS: UNCOVERING THE DAMAGE OF OFFSHORE BANKING AND TAX HAVENS* 11-12 (2011) (documenting the rise in offshore tax abuses); RICHARD MURPHY, *THE TAX GAP: TAX EVASION IN 2014 AND WHAT CAN BE DONE ABOUT IT* (2014) (estimating a one-year tax loss of £19 billion in the United Kingdom due to exploitation of tax loopholes).

¹³ See *infra* notes 34 - 59 and accompanying text.

¹⁴ See *infra* notes 71 - 78 and accompanying text.

¹⁵ See *infra* notes 81 - 97 and accompanying text.

The importance of a system of progressive income tax to stabilize market economies cannot be overstated. This is one of the primary lessons of the Great Depression.¹⁶ Unregulated markets generate great wealth, but they also tend to concentrate that wealth in the hands of the few.¹⁷ Without regulation the maldistribution can spiral out of control. The fear is that concentrated wealth will entrench first-mover advantages and enable the wealthy to capture government.¹⁸ Of course, distributional issues posed by free markets can be addressed with a variety of economic policies, including: (1) enhancement of labor unions; (2) robust enforcement of competition policies including antitrust; (3) raising the minimum wage; (4) eliminating insider trading, financial frauds, embezzlements, and other forms of white collar crime; and (5) reducing the monopolistic prerogatives afforded the holders of intellectual property.¹⁹ Some, or all, of these policies may be good ideas. They all tend to redistribute wealth. Yet the most effective and least disruptive means for assuring a fair share of income resides in a political commitment to a progressive income tax.²⁰ Such a view animates the spirit of tax codes worldwide. The commitment should also be respected in both tax practice and judicial interpretation. This article provides an argument for doing so.

II. TAXPAYER'S PERSPECTIVE

Part II begins with a few definitions and then explores the economic and psychological allure of tax shelters. The second section provides examples of tax-avoidance strategies including the use of step-transactions and international tax havens. The third inquires whether there is anything wrong with using these strategies for private gain, and if so, under what conditions and why. Part II closes with a brief summary.

A. *The Allure of Tax Shelters*

People like money, so it is not surprising that they generally pay taxes only when they feel either legally or ethically compelled to do so, with an emphasis on the former.²¹ Recent studies identify a so-called tax gap, defined as the difference between the income tax due and the income tax collected.²² According to the Internal Revenue Service (IRS), the tax gap in the United States totals about \$300 billion annually, or about one fifth of taxes due.²³ A similar gap is found in both the United Kingdom and in the European Union.²⁴ For example, in 2013, Her Majesty's Revenue and Customs (HMRC) collected £475 billion in taxes while an estimated £122 billion (one fifth) went unpaid.²⁵ Although there does not appear to be a global estimate of the tax gap, studies indicate that the

¹⁶ See generally JOHN KENNETH GALBRAITH, *ECONOMICS IN PERSPECTIVE* 132-33 (1987) (identifying "vulnerable points" in a capitalist system, including income inequality, which can generate instability).

¹⁷ See *id.* (noting the tendency for free markets to trend toward monopoly, which in turn, tends to concentrate wealth). See generally PIKETTY, *supra* note 9 (examining the reasons for income inequality).

¹⁸ See generally George J. Stigler, *The Theory of Regulation*, 2 BELL J. ECON. & MGMT. SCI. 3 (1971) (providing the seminal work on the so-called "capture theory"); Richard A. Posner, *Theories of Economic Regulation*, 5 BELL J. ECON. & MGMT. SCI. 335, 344 (1974) (explaining how firms use lobbying techniques, financial contributions, and the control of information to shape regulations in a way that secures first mover advantages).

¹⁹ See Reich, *supra* note 9 (listing several potential policy solutions to income inequality).

²⁰ See PIKETTY, *supra* note 9 (advocating a progressive income tax as the single best means of addressing growing income disparity).

²¹ See TOM TYLER, *WHY PEOPLE OBEY LAW* (1990) (examining empirical works examining why people obey legal rules, including but not limited to tax).

²² See, e.g., Her Majesty's Revenue & Customs, Corporate Report: HMRC issue briefing: Calculating the 2012 to 2013 tax gap, Oct. 16, 2014, [hereinafter: HMRC Report] available at <https://www.gov.uk/government/publications/hmrc-issue-briefing-calculating-the-2012-to-2013-tax-gap/hmrc-issue-briefing-calculating-the-2012-to-2013-tax-gap>; Government Accountability Office: *Tax Compliance*.

²³ See Report to the Committee on Finance, U.S. Senate, Washington D.C., July 2005, at 3. The IRS Report took several years to complete. It was the first comprehensive government assessment of tax fraud since 1988 [hereinafter IRS Report]. See generally Robert E. Brown & Mark J. Mazur, *IRS's Comprehensive Approach to Compliance Measurement* at 1 (June 2003) (discussing the methodology of the study).

²⁴ Taxation and Customs Union, *The Missing Part*, available at http://ec.europa.eu/taxation_customs/taxation/tax_fraud_evasion/missing-part_en.htm (last visited May 9, 2015).

²⁵ See MURPHY, *supra* note 12, at 2 (2014) (providing a critique of a recent tax study provided by Her Majesty's Revenue & Customs (HMRC) addressing the tax gap in the United Kingdom). Assessing the scope of certain evasions, Richard Murphy notes that "at most, 50 percent of the transactions resulting in a capital gain requiring

worldwide loss to tax havens alone totals about \$250 billion annually.²⁶ The tax gap appears to be a global phenomenon.

The tax gap, by definition, derives from three sources: tax evasion, tax insolvency, and tax avoidance.²⁷ Tax evasion involves criminal activity without recourse to legal excuse, such as failing to report self-employment income or deliberately falsifying a return. Evasion is a criminal offense typically punishable by imprisonment. Tax insolvency arises when a taxpayer files bankruptcy or otherwise becomes incapable of paying a tax. Tax avoidance refers to not paying a tax or paying a reduced tax based on the assertion of a strained, self-serving interpretation of tax law that one knows was not intended by the legislature, and if challenged, may not prevail in court.²⁸ Of course, if the taxpayer's interpretation were to prevail, then no additional tax would be due, and the failure to pay would not be within the tax gap. If the interpretation proves invalid, however, then the taxpayer must pay back taxes with interest and potentially a penalty. These back taxes would be included in the tax gap. In such cases, tax avoidance essentially equates to tax evasion under color of law. A recent study estimates that about two thirds of the tax gap in the United Kingdom derives from evasion, one sixth from insolvency, and one sixth from avoidance.²⁹

Tax-avoidance schemes, supported with self-serving interpretations of tax law, are sometimes referred to as "tax shelters." To understand their allure, note that tax shelters provide value to the taxpayer whether sound or not. When sound, the shelter provides an absolute defense to an IRS or HMRC challenge. Yet, even when unsound, the interpretation that generates the shelter provides value. First, the taxpayer's interpretation may never be challenged by the taxing authority. When unchallenged, the shelter reduces the tax paid essentially by default even though it is known at the time of filing that the shelter might fail.³⁰ Second, when challenged, the shelter provides a bargaining chip during plea negotiations where the taxing authority may want to avoid interpretive complexities and accept an offer of partial payment to avoid litigation. Third, whereas a mistake of law does not provide a defense in many settings, in tax litigation it often does, and the shelter, even if invalid, can often protect the taxpayer from imprisonment.³¹ Finally, the shelter, even if faulty, provides the taxpayer with a rationalization for an aggressive tax posture. This rationalization may provide a psychological balm on one's conscience. The rationalization also protects the taxpayer's reputation in the community. When challenged, the taxpayer simply asserts that they were following the letter of law, even though the court later declares the self-serving interpretation invalid. Studies suggest that there may be \$50 billion generated by illicit tax shelters in the U.S. economy annually.³²

declaration to U.K. tax authorities may actually be disclosed on UK tax returns by those liable to pay this tax." *Id.* at 32.

²⁶ See SHAXSON, *supra* note 12, at 28 (estimating that wealthy individuals hold about \$11.5 trillion secretly offshore and avoid \$250 billion in taxes worldwide).

²⁷ See MURPHY, *supra* note 9, at 5-6.

²⁸ See *id.* at 43. The term tax avoidance does not include every action that "avoids" taxes. For example, choosing to work less and to enjoy more leisure reduces one's income taxes, but would not be called "tax avoidance." Similarly, buying a tax-exempt bond would not constitute tax avoidance because the exemption is intended by the taxing authority to prompt the purchase. Purchasing the bond and claiming the exemption involves tax compliance, and might be referred to as tax minimization, but it would not be tax avoidance. As used in this study, tax avoidance means knowingly exploiting the letter of tax regulations in a way that is inconsistent with legislative intent and public policy. This usage conforms to the tax gap literature generally. See, e.g., *id.* (offering the same distinction).

²⁹ See *id.* at 2-4 (estimating that the 2013 U.K. gap included £85 billion in evasion, £19 billion in avoidance, and £18 billion due to insolvency).

³⁰ See David Quentin, *Risk-Mining the Public Exchequer: Reflecting the Realities of Tax Risk in the Theory of Tax Avoidance* (2014). In Quentin's view, tax avoidance arises when a taxpayer knowingly assumes a filing position that has a less than maximum certainty of prevailing in court. *Id.* at 13. Such positions create "tax risk." *Id.* Quentin contends that the knowing acceptance of tax risk, though not illegal, is unethical. *Id.* at 18. He also notes that the taxing authority is unlikely to challenge filing a position that has a greater than fifty percent chance of prevailing in court. *Id.* at 16. Unchallenged avoidance schemes are difficult, if not impossible, to measure and are not captured in estimations of the tax gap. *Id.* at 17. Hence, Quentin argues that tax gap numbers are systematically underreported.

³¹ See Dan M. Kahan, *Ignorance of the Law is an Excuse: But Only for the Virtuous*, 96 MICH. L. REV. 127, 145-46 (1997) (noting that an error in interpreting the tax code typically does not evoke a criminal sanction).

³² This number derives from the \$300 billion estimate of the U.S. tax gap, see IRS Report, *supra* note 25 and accompanying text, and the one-sixth proportion attributed to avoidance in the United Kingdom, see MURPHY, *supra* note 26 and accompanying text.

B. Tax-Avoidance Strategies

Tax planners create value for their clients, in part, by exploiting imprecise language found in legal texts. Sometimes this means interpreting ambiguous tax regulations in a self-serving ways. Consider, for example, the incentive created by Section 162 of the Internal Revenue Code which allows corporate taxpayers to deduct "ordinary and necessary expenses [including] a reasonable allowance for salaries or other compensation for personal service actually rendered."³³ The provision invites corporations to pay excessive wages to share-holding executives so as to deduct the expense and to avoid the double taxation posed by dividends.³⁴ Interestingly, one finds a reverse incentive in the United Kingdom, where the payment of dividends avoids the national insurance charges apportioned to wage earners.³⁵ Tax planners in the United States encourage wages;³⁶ in the United Kingdom they encourage dividends. In each case, if audited and challenged by the tax authorities, the corporation in question cites the professional tax advice, asserts the propriety of its interpretation, and seeks to remove the matter from the criminal ledger to the civil. The issue is not tax evasion, but tax avoidance, which can be part of the tax gap, but typically does not include jail-time. The dispute probably results in a settlement.

1. Step Transactions

A step transaction provides a common interpretative trick with which to avoid taxes, wherein a party seeks to accomplish a goal indirectly that would be contrary to law if done directly.³⁷ Consider, for example, the "gift-loan-back" strategy.³⁸ A married couple owns a restaurant and has a son who is entering dental school with a significant annual tuition. Paying college tuition is not deductible. The parents' tax advisor proposes a step transaction. Each parent gives the son a series of annual gifts taken from their business.³⁹ The son then loans the money back to the business and the parents, as owners, agree to pay the son an annual interest of fifteen percent, which is deductible from their business income. The son declares the interest as income, but he is in a very low bracket and may pay no income tax at all.⁴⁰ The son uses the interest income to pay annual tuition. Once the son has established his dental practice, he systematically returns the principal to his parents through a series of gifts.

Each step above appears beyond reproach; yet, taken collectively the result seems to violate the law. There is nothing wrong with parents making a series of gifts, a business receiving a series of loans, paying interest on those loans, or deducting the interest paid. Yet, when linked, the steps achieve a result contrary to law, the tuition payments are deducted by the parents.

Similarly, Walmart Corporation recently transferred a store to a wholly-owned subsidiary, rented the store from the subsidiary, and deducted the rent.⁴¹ The rental payments were then paid to Walmart as a dividend, which under applicable state law are not subject to state income tax.⁴² Nothing had changed other than the formal owner of

³³ I.R.C. § 162(a)(1) (2006).

³⁴ See generally Andrew W. Stumpff, *The Reasonable Compensation Rule*, 19 VA. TAX REV. 371 (1999) (outlining the interpretive issues involved).

³⁵ See MURPHY, *supra* note 9, at 43.

³⁶ See Beth Stetson, et al., *Courts Don't Follow: Reasonable Compensation Rulings and the Exacto Spring Approach*, 15 CHAPMAN L. REV. 343, 343-34 (2011) (discussing the economic incentives of the provision).

³⁷ See Martin J. McMahon, Jr., *Random Thoughts on Applying Judicial Doctrines to Interpret the Internal Revenue Code*, 54 SMU L. REV. 195, 197-200 (2001) (illustrating step transactions found in two classic cases).

³⁸ See generally LEO KATZ, *ILL-GOTTEN GAINS: EVASION, BLACKMAIL, FRAUD, AND KINDRED PUZZLES OF THE LAW* 5-6 (1996) (discussing the gift-loan-back strategy and noting that judicial responses to the strategy can be difficult to predict).

³⁹ Each parent is permitted to give a child \$14,000 per year without paying a gift tax. See Internal Revenue Service, *Frequently Asked Questions on Gift Taxes*, available at <http://www.irs.gov/Businesses/Small-Businesses-&Self-Employed/Frequently-Asked-Questions-on-Gift-Taxes> (last visited May 10, 2015).

⁴⁰ The law requires merger of a dependent child's unearned income with the income of the parents if the child's income is earned before their eighteenth birthday. *Id.* Presumably, the dental student has reached adulthood.

⁴¹ See Jesse Drucker, *Wal-Mart Cuts Taxes by Paying Rent to Itself*, WALL ST. J., Feb. 1, 2007, at A1.

⁴² See *id.*

the store, as the owners of both entities were identical, but Walmart's income tax dropped. The state taxing authority challenged the practice and the declared the scheme a sham, charging Walmart with back taxes.⁴³

When faced with an attempt to skirt the law with a hyper-literal interpretation of the tax code, the IRS, like the state authority in the *Walmart* case, typically takes the position that the series of steps should be integrated into one transaction.⁴⁴ Hence, the parent's attempt to deduct dental-school tuition, if audited, may face a challenge, and the challenge may be upheld.⁴⁵ On the other hand, there may be no audit or the taxpayer's literal interpretation may prevail.

The potential for the self-reported tax to remain unaudited or for the taxpayer's interpretation to prevail in court provides an incentive for so-called *risk mining*.⁴⁶ Risk mining involves the systematic use of an aggressive tax posture to exploit imprecise language in the tax code. In cases of aggressive tax avoidance, the advisor knows that the filing position may be unsound, but advises that the risk be accepted. The "risk," of course, rests with the British Exchequer or U.S. Treasury, not with the taxpayer.⁴⁷ Ineffective avoidance typically involves the paying of back taxes; effective avoidance is either not detected or not fully sanctioned. In addition, the taxing authority seems unlikely to challenge a filing position where the likelihood that the taxpayer's interpretation prevails is greater than fifty percent.⁴⁸ In such cases, the taxpayer wins by default, and the exchequer collects less tax than is due. The missing sum remains unmeasured and does not appear in tax gap numbers. This suggests that step transactions and similar forms of tax avoidance may be more common than currently estimated.

2. International Tax Havens

An international tax haven has been defined as "a place that seeks to attract money by offering politically stable facilities to help people or entities get around the rules, laws, and regulations of jurisdictions elsewhere."⁴⁹ Tax havens prove to be politically stable because foreign investors tend to control local governments and to suppress criticism.⁵⁰ Tax havens typically offer a zero income tax on earnings derived from money invested from overseas together with strict privacy rules to protect bank records and organizational secrets.⁵¹ London-influenced tax havens include the islands of Jersey, Guernsey and the Isle of Man with an estimated one trillion dollars on deposit.⁵² The Cayman Islands, also a tax haven, hosts eighty-thousand registered companies, three-fourths of the world's hedge funds, and has \$1.9 trillion on deposit, four times as much as all the banks in New York City.⁵³ The Cayman Islands has a population of fifty-five thousand and one cinema.⁵⁴ Other tax havens include Luxemburg, Ireland, and Bermuda.⁵⁵

⁴³ See Jeremy M. Wilson, *Statutory Interpretation in Wal-Mart Stores East, Inc. v. Hinton and Why North Carolina Courts Should Apply Anti-tax Avoidance Judicial Doctrines in Future Cases*, 88 N.C. L. REV. 1471 (2010) (providing a thorough discussion of the Walmart case).

⁴⁴ See David J. Herzig, *Am I the Only Person Paying Taxes? The Largest Tax Loophole for the Rich—Exchange Funds*, 2009 MICH. ST. L. REV. 503, 531 (2009).

⁴⁵ Judicially created theories regarding step-transactions include the "end result," "binding commitment," and "mutual interdependence" tests. See, e.g., *Kanawha Gas & Utils. Co. v. Comm'r*, 214 F.2d 685, 691 (5th Cir. 1954) (finding a step transaction under the end result test when a "series of transactions [are] designed and executed as parts of a unitary plan to achieve an intended result"); *Comm'r v. Gordon*, 391 U.S. 83, 96 (1968) ("If one transaction is to be characterized as a 'first step' there must be a binding commitment to take the later steps."); *Am. Bantam Car Co. v. Comm'r*, 177 F.2d 513 (3d Cir. 1949) (holding that evidence of a common plan include the *mutual interdependence* and temporal proximity of the acts).

⁴⁶ See Quentin, *supra* note 30.

⁴⁷ See *id.* at 16.

⁴⁸ See *id.* at 17.

⁴⁹ SHAXSON, *supra* note 9, at 11.

⁵⁰ See *id.* at 13.

⁵¹ See *id.* at 12. Shaxson observes that tax havens often "offer a zero tax rate to non-residents who park their money there but tax local residents fully." *Id.*

⁵² See Martin A. Sullivan, *Offshore Explorations: Jersey*, TAX NOTES (Oct. 23, 2007).

⁵³ See SHAXSON, *supra* note 9, at 18.

⁵⁴ See *id.*

⁵⁵ See *id.* at 13-14. In 2014, leaked documents from PricewaterhouseCoopers (PwC) showed that hundreds of well-known multinational enterprises have secured secret tax agreements with Luxembourg saving billions of tax dollars

Multinational corporations reduce their taxes by transferring income to tax havens. Consider, for example, the market for coffee.⁵⁶ Coffee beans are picked in Guatemala by a worker employed by King Coffee, a hypothetical multinational corporation domiciled in the United States. The beans are packaged and shipped to the United Kingdom, sold to a supermarket, and then sold to a customer. Where the profits are reported depends on how King Coffee is structured. This can be complicated. King Coffee may run its purchasing through a Cayman Island subsidiary, run its financing through a subsidiary in Ireland, register its brand name in Bermuda, self-insure through a wholly-owned subsidiary in the Isle of Man, and locate its management consulting services in Luxembourg. Each King-Coffee subsidiary charges the other subsidiaries or King Coffee itself for the services provided. The prices, of course, are artificial because the buyer and seller in every case are both owned by the same multinational corporation.⁵⁷ Where the profits are reported depends on the firm's organizational structure and transfer prices chosen; both tend to shift income from high tax to low tax venues.⁵⁸

C. The Ethics of Legal Interpretation

The exploitation of imperfections in the law can be profitable. The question becomes whether there is anything wrong with using tax-avoidance-strategies such as step transactions that shift income to global tax havens. Ultimately, the answer to this question depends on how one perceives one's duty to obey law. This section examines some nuances of legal obedience and explores the ethical standards of professionals who advise on such matters.

1. Duty to Obey Law

Corporate executives owe a fiduciary obligation to pursue shareholder desires. This typically means maximizing the firm's economic returns. Yet, this economic goal must be subordinate to legal and ethical constraints.⁵⁹ Shareholders have no legal power to authorize executives to break the law; corporate returns must be pursued legally.⁶⁰ Similarly, shareholders have no moral authority to require an executive to behave in an unethical fashion.⁶¹ Properly conceived, the executive's role is to maximize shareholder returns through legal and ethical means.

In his influential treatise, *A Theory of Justice*, philosopher John Rawls articulated his notion of a perfectly just society with particular reference to the business enterprise.⁶² Although Rawls focused primarily on the topics of political economy and political philosophy, he also addressed individual ethics. In Rawls' just society, every citizen

each year. See The International Consortium of Investigative Journalists, *Luxembourg Leaks: Global Companies' Secrets Exposed*, available at <http://www.icij.org/project/luxembourg-leaks> (last visited April 3, 2015).

⁵⁶ See SHAXSON, *supra* note 9, at 13-14 (constructing a similar example).

⁵⁷ About two-thirds of international transactions derive from internal transfers within multinational corporations rather than through arms-length transactions between independent buyers and sellers. See *id.* at 14-15. The manipulation of transfer prices can generate fraudulent tax benefits for multinational enterprises. See generally Organization for Economic Co-operation and Development, TRANSFER PRICING GUIDELINES FOR MNEs AND TAX ADMINISTRATIONS (2010) (providing guidance on the "arm's length principle" necessary for the legitimate valuation of cross-border transactions within a multinational enterprise), available at www.oecd.org/tax/. A detailed discussion of the regulation of this type of fraud is beyond the scope of this article.

⁵⁸ See *id.*

⁵⁹ As Milton Friedman stated in his oft-cited essay on the topic of corporate social responsibility, the proper goal for the business executive is "to make as much money as possible while conforming to the basic rules of society, both those embodied in law and those embodied in ethical custom." Milton Friedman, *The Social Responsibility of Business Is to Increase Its Profit*, N.Y. TIMES MAG., Sept. 13, 1970, at 32 (emphasis added).

⁶⁰ The duty to obey law alternatively has been grounded to the utilitarian calculus of Bentham and Mill, to the social contract theories of Hobbes and Locke, and to a "natural duty to support just institutions" associated with the philosophical works of John Rawls. See M.B.E. Smith, *Is There a Prima Facie Obligation to Obey Law?*, in THE DUTY TO OBEY LAW: SELECTED PHILOSOPHICAL READINGS 75, 77-93 (William A. Edmundson ed., 1999) (articulating a critique of each justification). But see Robert Paul Wolff, *The Conflict between Authority and Autonomy*, in DEFENSE OF ANARCHISM 3-19 (1971) (denying that there is a prima facie duty to obey law).

⁶¹ See Joseph S. Spoerl, *The Social Responsibility of Business*, 42 AM. J. JURIS. 277, 278-79 (1997) (offering the same insight); Kenneth E. Goodpaster, *Business Ethics and Stakeholder Analysis*, 1 BUS. ETHICS Q. 53, 68 (1991).

⁶² JOHN RAWLS, A THEORY OF JUSTICE (1971).

embraces a duty of civility.⁶³ Civility, in turn, requires the support of reasonably just social institutions, including the administration of justice.⁶⁴ As a corollary, Rawls addressed legal loopholes. He wrote:

[We] have a natural duty of civility not to invoke the faults of social arrangements as a too ready excuse for not complying with them, not to exploit inevitable loopholes in the rules to advance our interests. The duty of civility imposes a due acceptance of the defects of institutions and a certain restraint in taking advantage of them.⁶⁵

Hence, for Rawls, the corporate executive remains free to advance shareholder interests, but the executive must support the institutions of public justice, not erode them. This would seem to include due deference to the social policies that inform specific business regulations and cooperation with the formulation and implementation of the regulatory environment generally.⁶⁶

Applying Rawls's notion of justice to tax-avoidance strategies, one finds the need for corporate self-restraint.⁶⁷ Step transactions and tax havens provide perverse incentives to erode the policy goals that support tax systems, namely, fairness, simplicity, and certainty.⁶⁸ Step transactions and transfer pricing schemes appear complex and convoluted by design. Their enforceability in a court of law seems uncertain, and use of such strategies generates distrust and a sense of unfairness among taxpayers generally. It also seems that given the voluntary compliance nature of income tax system generally, the taxing authority needs a perception of fairness to encourage people to cooperate with the public policies that underlie the system.⁶⁹ Disrespect for tax law can turn self-reporting into an arena for self-dealing and calculated evasion.

Since 1998, the Organization for Economic Co-operation and Development (OECD) has promoted a global initiative to reduce "harmful tax practices" with particular emphasis on the elimination of transfer pricing abuses facilitated by international tax havens.⁷⁰ By definition, these harmful tax practices lack transparency while simultaneously achieving low, non-existent, or nominal tax rates without the need for substantial domestic activities.⁷¹

In 2011, the OECD published guidelines regarding impropriety of overly aggressive tax interpretations and the corresponding duty to cooperate with the spirit of the law, stating:

Corporate citizenship in the area of taxation implies that enterprises should comply with both the letter and the spirit of the tax laws and regulations in all countries in which they operate, co-operate with authorities and make information that is relevant or required by law available to them. An enterprise complies with the spirit of the tax laws and regulations if it takes reasonable steps to determine the intention of the legislature and *interprets those tax rules consistent with that intention* in light of the statutory language and relevant, contemporaneous legislative history.⁷²

⁶³ *Id.* at 355.

⁶⁴ *Id.*

⁶⁵ *Id.*

⁶⁶ See LEE E. PRESTON & JAMES E. POST, PRIVATE MANAGEMENT AND PUBLIC POLICY 100 (1975) (identifying cooperation with the public policy process as the *sin qua non* of socially responsible corporate behavior).

⁶⁷ See Reuven S. Avi-Yonah, *Corporate Social Responsibility and Strategic Tax Behavior*, Working Paper 2006 (looking at a corporation through three distinct lenses and concluding that under each view a responsible corporation should not use strategic tax behavior to reduce corporate tax and that courts should use tax to promote goals associated with corporate social responsibility).

⁶⁸ See Jeffrey Partlow, *The Necessity of Complexity in the Tax System*, 13 WYO. L. REV. 305 (2013) (noting that the goal of simplicity often conflicts with the goals of certainty and fairness).

⁶⁹ See Richard J. Kovach, *Taxes, Loopholes and Morals Revisited: A 1963 Perspective on the Tax Gap*, 30 WHITTIER L. REV. 247 (2008) (surveying normative reasons that might encourage or discourage a taxpayer to cooperate with a taxing authority).

⁷⁰ See Akiko Hishikawa, *Death of Tax Havens?*, 25 B.C. INT'L & COMP. L. REV. 389, 391 (2002) (discussing OECD's Project on Harmful Tax Practices); see also Center for Tax Policy and Administration, *The OECD's Project on Harmful Tax Practices: The 2001 Progress Report*, (Nov. 14, 2001).

⁷¹ See Hishikawa *supra* at 391.

⁷² Organization for Economic Co-operation and Development, *OECD Guidelines for Multinational Enterprises*, chapter XI (on taxation) (2011) (emphasis added).

Hence, pursuant to OECD guidelines in the tax arena, the law-obeying taxpayer must exercise self-restraint and abide by a reasonable interpretation of the tax code, resisting the temptation to stretch that interpretation solely for private gain.

2. Professional Tax Advisors

A taxpayer typically chooses a tax avoidance strategy only after receiving advice from an attorney, certified public accountant, or other professional tax planner. These professionals interpret tax regulations and offer opinions regarding the likelihood that a particular filing position will be upheld. A position that fails when challenged typically requires the paying of back taxes with interest, but it would be unlikely to evoke an additional penalty if there was a "realistic possibility" that the underlying tax interpretation would be upheld.⁷³ Pursuant to federal regulations, an interpretation has a realistic possibility of success if it has "one-in-three" chance that it will be found valid in court.⁷⁴

Partly due to the one-in-three rule, aggressive tax-planning has become the norm, rather than the exception. The rule encourages planners to promote tax interpretations that they know are likely to be invalid.⁷⁵ Critics contend that the taxing authority should modify this confidence-level standard, change the way advice is given, and eliminate hyper-literal interpretations of law in favor of complying with more coherent or purposive interpretations.⁷⁶ For example, the confidence-level rule could require the planner to assert the "most-likely" interpretation of tax law, with due deference to the language of the legal text, prior interpretations, trends in the precedents, and public policy.⁷⁷ A faulty interpretation, even if it offered a realistic possibility (one third) of success *ex ante*, would generate a penalty if it were not offered as a good faith attempt to live to the most-likely interpretation of the taxpayer's filing position.⁷⁸ The threat of penalties could change the economic calculus that supports hyper-literal interpretations including step-transactions and transfer of income to international tax havens that exacerbates the current tax gap.

D. *Summary*

Funneling money through tax shelters can prove profitable. Hyper-literal interpretations of law often go unchallenged, and if challenged, the interpretations sometimes prevail. Tax law typically disallows jail-time for taxpayers who rely on professional tax advice, even when that advice proves invalid. Under current law, if the faulty advice had a one-in-three chance of success, then no penalties are due. Given these factors, it seems unsurprising that taking an aggressive tax posture has become the norm and the use of international tax havens has become so prevalent. OECD guidelines, of course, entreat executives at multinational enterprises to resist the temptations posed by legal loopholes and to voluntarily pay a fair share of tax. Yet, appeals to social responsibility and ethics will only go so far in the face of temptation, and legal reforms seem necessary to change economic incentives posed by international tax havens.

⁷³ See Treas. Reg. § 1.6694-2 (1991).

⁷⁴ See *id.*

⁷⁵ See Quentin, *supra* note 30 and accompanying text (discussing the potential for risk mining).

⁷⁶ See, e.g., Linda M. Beale, *Tax Advice Before the Return: The Case for Raising Standards and Denying Evidentiary Privileges*, 25 VA. TAX REV. 583 (2006). (proposing to raise pre-return advice standard to more than "one-in-two", or alternatively, to "more-likely-than not"); Diane A. DiLeo, *Loopholes in Federal Income Taxation: Solutions for Charitable Trust Abuse and Potential Application to Corporate Tax Shelter Abuse*, 36 SUFFOLK U.L. REV. 207 (2002) (contending that the IRS should be "targeting not only taxpayers, but also their accountants, attorneys, and financial planners, who are the true catalysts for concocting these schemes"); David Weisbach, *It's Time to Get Serious About Shelters*, 88 TAX NOTES 1677, 167 (2000) (stating that "tax planning deserves very little protection").

⁷⁷ Potential standards include: (1) most-likely standard; (2) more-likely-than not standard (greater than 50%); (3) substantial authority (at least 40% likelihood); (4) realistic possibility (at least 33% likelihood); and (5) not-frivolous standard (at least 10% likelihood). See Beale, *supra* at 594. n.27 & n.28 (citing Treas. Regs. 1.6662-4(d)(2); Treas. Regs. 1.6662-3(b)(3)).

⁷⁸ See generally Calvin H. Johnson, *True and Correct: Standards for Tax Return Reporting*, 43 TAX NOTES 1521 (1989) (advocating that a taxpayer's duty at the time of filing is to state the "correct" amount of tax due).

III. JUDICIAL RESPONSES

The discussion now turns to judicial responses to hyper-literal interpretations of tax law. Part III begins with an examination of anti-tax-avoidance doctrines such as the principle of substance over form and the business purpose rule. These doctrines enable the courts to close tax shelters by disallowing hyper-literal interpretations in favor of more purposive and pragmatic interpretations. Part III closes with the topic of legal philosophy, comparing and contrasting a jurisprudence of positive-legal formalism that tends to support literal interpretations of law, with legal pragmatism that supports a more policy-oriented approach.

A. Anti-Tax-Avoidance Doctrines

Courts in the United States, including the U.S. Supreme Court, have developed a set of interpretive doctrines addressing overly aggressive tax avoidance. These include the "substance over form," sham-transaction," "business purpose," "step-transaction," and "economic substance" doctrines.⁷⁹ Courts use these doctrines to resolve tax disputes when the direct appeal to the literal language of a tax statute appears inadequate.⁸⁰ The doctrines are closely related, and no single formulation has done all the work.⁸¹ Collectively, the five doctrines reflect an acknowledgement by the judiciary that in drafting tax legislation, Congress cannot anticipate every circumstance where a taxpayer may seek to take advantage of statutory language in a way that was neither anticipated nor intended.⁸²

Anti-tax-avoidance (ATA) doctrines enjoy a long lineage in the United States. The principle of *substance over form* traces to a 1921 Supreme Court case recognizing "the importance of regarding matters of substance and disregarding forms in applying the provisions of the Sixteenth Amendment and income tax laws enacted there under."⁸³ That precedent confirmed that lower courts were to ignore the form of a tax transaction if that form had no substantive content. The idea of a *sham transaction* appears in a 1940 Supreme Court case emphasizing that lower courts "may look at actualities and upon determination that the form employed for doing business or carrying out the challenged tax event is unreal or a sham may sustain or disregard the effect of the fiction as best serves the purposes of a tax statute."⁸⁴

A third ATA doctrine, the *business purpose rule*, originates in the 1935 case of *Gregory v. Helvering*.⁸⁵ Gregory attempted to acquire a set of shares from her investment company without reporting a dividend and to resell those shares at a favorable tax rate.⁸⁶ Her investment company first transferred the shares to a newly formed company which then transferred the shares to her and dissolved.⁸⁷ Taken collectively, these steps satisfied the then-existing literal requirements for a tax-free "reorganization," so no dividend was declared.⁸⁸ Gregory later sold the shares and asserted the capital gains rate. The Supreme Court stated that Congress had intended that reorganizations done pursuant to a business purpose should receive favorable tax treatment, but that Gregory had no purpose other than to avoid taxes.⁸⁹ The favorable tax treatment was disallowed.

Gregory may be the most frequently cited Supreme Court case dealing with tax avoidance.⁹⁰ Although typically discussed with reference to the business purpose rule, the case also has proved foundational to the *economic substance* doctrine.⁹¹ Pursuant to this doctrine, for a taxable event to receive favorable tax treatment, there must be an *economic motive* behind the event and the event must produce an *economic effect* other than to

⁷⁹ See Jerome B. Libin, *Congress Should Address Tax Avoidance Head-On: The Internal Revenue Code Needs a GAAR*, 30 VA. TAX REV. 339, 340 (2010).

⁸⁰ See *id.*

⁸¹ See Joseph Bankman, *The Economic Substance Doctrine*, 75 S. CAL. REV. 5, 6 (2000).

⁸² See James Halpern, *Tax Exceptionalism: Is Tax Law Really Different from Other Areas of Law?*, 30 VA. TAX REV. 327 (2010) (examining the inherent limitations of statutory language and the judicial attempt to address these limits).

⁸³ *United States v. Phellis*, 257 U.S. 156, 168 (1921).

⁸⁴ *Higgins v. Smith*, 308 U.S. 473, 477 (1940).

⁸⁵ *Gregory v. Helvering*, 293 U.S. 465 (1935).

⁸⁶ *Id.* at 467.

⁸⁷ *Id.*

⁸⁸ *Id.*

⁸⁹ *Id.* at 470.

⁹⁰ Libin, *supra* note 79, at 342.

⁹¹ See Bankman, *supra* note 81, at 8.

reduce taxes.⁹² These two criteria (motive and effect) establish the "subjective" and "objective" arms of the economic substance test.⁹³ Whereas courts split on whether a subjective motive establishes economic substance without proof of an objective effect,⁹⁴ an effect without motive typically suffices.⁹⁵ Illustrating the interchangeable nature of ATA doctrines, the subjective arm of the economic substance doctrine essentially equates to the business purpose rule.⁹⁶ Both focus on motive. In fact, the avoidance issues in *Gregory* could have been addressed as a sham transaction, as a step-transaction, as substance over form, under the economic substance test, or under the business purpose rule.⁹⁷ The five interrelated ATA doctrines empower courts with a set of tools with which to attack avoidance schemes.⁹⁸

B. Legal Philosophy

Notwithstanding the long lineage of ATA cases, the application of the doctrines has always been controversial.⁹⁹ Over time, a wide array of legal commentators has addressed the wisdom of ATA formulations, the appropriate uses of the doctrines, and the potential for abuse.¹⁰⁰ At the heart of the debate, one finds fundamentally different views of legal philosophy.¹⁰¹ Some commentators argue that tax courts need to strictly adhere to the techniques of formal legal reasoning, or legality, with sole appeal to linguistic analysis and legislative intent.¹⁰² For these scholars, certainty, predictability, and simplicity provide the measures of legitimacy.¹⁰³ Other scholars contend that these goals are quixotic.¹⁰⁴ They argue that given the recent growth in tax avoidance behavior, a more

⁹² See *id.* at 13-17, 26-29.

⁹³ See *id.*

⁹⁴ See *id.* 26.

⁹⁵ See *id.* at 13-17.

⁹⁶ See *id.* at 27.

⁹⁷ See Libin, *supra* note 79, at 343.

⁹⁸ The Internal Revenue Code recognizes and incorporates the common law doctrines of economic substance and the business purpose, but does not expand upon them. The Code states that the "economic substance doctrine means the common law doctrine under which tax benefits under subtitle A with respect to a transaction are not allowable if the transaction does not have economic substance or lacks a business purpose." I.R.C. § 7701(o) (5)(A)(2012). "The determination of whether the economic substance doctrine is relevant to a transaction shall be made in the same manner as if this subsection had never been enacted." I.R.C. § 7701(o) (5)(C)(2012). "In the case of any transaction to which the economic substance doctrine is relevant, such transaction shall be treated as having economic substance only if—(A) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and (B) the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction," I.R.C. § 7701(o)(1)(2012). Section 7701 concludes that "achieving a financial accounting benefit shall not be taken into account as a purpose for entering into a transaction if the origin of such financial accounting benefit is a reduction of Federal income tax." I.R.C. § 7701(o)(4)(2012).

⁹⁹ See Bankman, *supra* note 81, at 5.

¹⁰⁰ *Id.*

¹⁰¹ See generally Assaf Likhovski, *The Duke and the Lady: Helvering v. Gregory and the History of Tax Avoidance Adjudication*, 25 CARDOZO L. REV. 953 (2004) (examining the role of tax judge's jurisprudence).

¹⁰² See, e.g., Beth Stetson, et al., *Courts Don't Follow: Reasonable Compensation Rulings and the Exacto Spring Approach*, 15 CHAPMAN L. REV. 343, 361 (2011) (bemoaning an appeal to economic results as outside the proper limits of legal inquiry).

¹⁰³ See, e.g., John F. Coverdale, *Text as Limit: A Plea for a Decent Respect for the Tax Code*, 71 TUL. L. REV. 1501, 1507 (1997) (arguing in favor of literal interpretations of the Internal Revenue Code as a means of promoting certainty and predictability).

¹⁰⁴ See, e.g., Richard J. Kovach, *Taxes, Loopholes and Morals Revisited: A 1963 Perspective on the Tax Gap*, 30 WHITTIER L. REV. 247, 275-76 (2008) (reviewing the interplay between taxpayers who seek loopholes and taxing authorities who seek to close them); Jeffrey Partlow, *The Necessity of Complexity in the Tax System*, 13 WYO. L. REV. 305 (2013) (noting that simultaneously seeking tax fairness and tax simplicity seems paradoxical because one goal tends to subvert the other); Brian J. Arnold, *The Interpretation of Tax Treaties – Myth and Reality*, BULL. INT'L TAX'N (2010) (noting that a "rigid, literal interpretation" of tax treaties and tax statutes often leads to "ridiculous" results).

pragmatic and results-oriented inquiry is necessary.¹⁰⁵ This requires the courts to move beyond linguistic analysis of legal texts, and beyond inquiries in legislative history, and toward a normative inquiry regarding both the ends sought by tax legislation, and the best means for achieving those ends.¹⁰⁶ The judicial inquiry must be practical and rooted in empirical results.¹⁰⁷

The following subsections engage this jurisprudential controversy. The discussion begins with positive-legal formalism. It then turns to legal pragmatism.

1. Positive-Legal Formalism

Legal formalism stands for the proposition that objectively correct answers to legal questions can and should be found through conceptual reasoning techniques.¹⁰⁸ Formalism begins by identifying the central tenets of the law in question from which legal answers can be deduced.¹⁰⁹ The positive version of legal formalism asserts that this deductive technique should be applied solely to legal materials — statutes, regulations, precedents and the like.¹¹⁰ Positivists, of course, contend that law is or should be independent of morality.¹¹¹ Formalism renders irrelevant empirical matters such as the political leanings of the judge, trends in social policy, the empirical consequences of a given decision, or any other referent other external to legal texts.¹¹² Under positive-legal formalism (PLF), law becomes an autonomous set of rules and exceptions to rules, derived solely from legal texts, to which deductive logic is applied.¹¹³

¹⁰⁵ See, e.g., Kyle D. Logue, *Tax Law Uncertainty and the Role of Tax Insurance*, 25 VA. TAX REV. 339, 349-51 (2009) (examining empirically-verifiable reasons why people obey or disobey law and suggesting reforms to encourage legal obedience).

¹⁰⁶ See, e.g., Weisbach, *supra* note 76, at 247-48 (offering a pragmatic discussion on rules versus standards and the role of uncertainty).

¹⁰⁷ See, e.g., Diane A. DiLeo, *Loopholes in Federal Income Taxation: Solutions for Charitable Trust Abuse and Potential Application to Corporate Tax Shelter Abuse*, 36 SUFFOLK U.L. REV. 207, 225-26 (2002) (explaining the dynamic evolution of rules, circumvention, more rules, and suggesting that government should target "not only taxpayers, but also their accountants, attorneys, and financial planners, who are the true catalysts for concocting these schemes"); Richard Lavoie, *Subverting the Rule of Law: The Judiciary's Role in Fostering Unethical Behavior*, 75 U. COLO. L. REV. 115 (2004) (arguing that overly formalistic jurisprudence, such as the "Textualism" associated with Justice Antonin Scalia, promotes unethical business practices by severing the link between moral and legal norms).

¹⁰⁸ See Ernest J. Weinrib, *Legal Formalism: On the Immanent Rationality of Law*, 97 YALE L.J. 949, 951-57 (1988) (defining formalism).

¹⁰⁹ See RICHARD A. POSNER, *THE PROBLEMS OF JURISPRUDENCE* 14-15 (1990). Richard Posner observes that formalists seek answers to legal questions from "a handful of permanent, unchanging, indispensable principles of law imperfectly embodied in the many thousands of published opinions." *Id.* He continues: "Once these principles [are] brought to light the correct outcome of a case could be deduced." *Id.* at 15.

¹¹⁰ Positive-legal formalism took shape in the United States during the late-nineteenth century, most notably in the hands of Christopher Langdell. See Daniel T. Ostas, *Postmodern Economic Analysis of Law*, 36 AM. BUS. L.J. 193, 198-99 (1998). Langdell's version of legal formalism has three defining characteristics: (1) law is autonomous, that is, not dependent on moral or social inquiries; (2) reasoning is conceptual, rather than empirical; and (3) objectively correct legal answers exist. See *id.* It is this strand of positive-legal formalism that is discussed in this section.

¹¹¹ Natural law reasoning also employs the conceptual reasoning techniques of legal formalism. See generally POSNER, *supra* note 109, at 10-11 (1990) (using the term legal formalism to refer to reasoning techniques which may or may not exclude morality). But natural law locates the central tenets of law in morality, rather than legal texts. The Langdellian version of legal formalism is distinctively positivistic.

¹¹² See generally Michael Corrado, *The Place of Formalism in Legal Theory*, 70 N.C. L. REV. 1545, 1545 (1992) (equating positive-legal formalism with the notion that legal inquiry is immune from moral inquiry or other external referent).

¹¹³ The outcome of many legal disputes is predictable. This is particularly true when the law is stable and the facts of the case are not in dispute. See Posner, *supra* note 12, at 30-31 (resisting the notion that law is radically indeterminate). The outcomes of debates over tax avoidance, by contrast, are notoriously difficult to predict. See McMahon, *supra* note 37, at 195.

Tax law embraces a jurisprudence of PLF perhaps more than any other area of law.¹¹⁴ A number of reasons present themselves. First, tax regulations typically constitute mala prohibitum in that they have no direct moral basis.¹¹⁵ The tax code taken collectively may be rooted in moral values such as fairness and efficiency, but there is no direct moral basis for why an asset is depreciable as a capital expenditure in one setting and fully deductible as a business expense in another.¹¹⁶ The dictates of the specific regulation establish the proper treatment of the taxable event, not morals, so a positive approach to law seems appropriate. Second, tax concerns play a prominent role in business planning, and PLF is expressed in the rhetoric of predictability and precision.¹¹⁷ In fact, PLF seems to anoint certainty and predictability as the chief goal of tax analysis, and these values facilitate planning. Finally, the language of PLF seems to dominate tax opinions and tax analysis, and this dominance has created a momentum of its own. The jurisprudential view seems to be the referent point for most scholarly discussions of tax generally.

It may be important to allay two misconceptions about PLF. First, note that PLF does not equate to literalism.¹¹⁸ The approach emphasizes principles of statutory interpretation which begins with a literal reading, but also includes references to legislative intent, general public policies, prior interpretations, and maxims of construction.¹¹⁹ Under the plain meaning rule the analysis may truncate with a dictionary definition, but the rule is not applied in all interpretative activities.¹²⁰ Legislative intent, complete with its incumbent vagaries, often compounds matters. Hence, PLF embraces statutory interpretation, not literalism.¹²¹ Second, PLF is not about judicial-legislative relations. The philosophy does not elevate legislation above judicial precedent. Legislation is to be interpreted in light of judicial precedents, and those precedents can help define legislative intent.¹²² In addition, the philosophy respects the common law tradition; it simply seeks to limit common law analysis to the cases themselves and insists that that analysis follows familiar and widely accepted modes of conceptual reasoning with no reference to empirical matters outside the courtroom.

The question for proponents of PLF is whether its quest for certainty and predictability comes at too great a cost to efficiency and efficacy. If a philosophy of PLF wastes too many resources and renders the tax code

¹¹⁴ See generally Logue, *supra* note 105, at 363 ("The tax system is the quintessential rule-based, as opposed to a standards-based, legal regime.").

¹¹⁵ See Kahan, *supra* note 31, at 148-49.

¹¹⁶ See *id.* Dan Kahan observes that if law has a direct moral component (*malum in se*) then taking advantage of a loophole or not knowing the law is condemned by the courts. *Id.* at 137-45. The idea is that one ought to comply with the moral underpinnings of a law when those underpinnings are clear. Kahan contends that tax laws are unique because their complexity makes it difficult to locate any moral purpose to the law. *Id.* at 146. Kahan suggests that this explains why tax avoidance schemes typically are not punishable in criminal proceedings. *Id.* at 148-49.

¹¹⁷ See generally Coverdale, *supra* note 102, at 1507 (defending strict adherence to textual interpretations of the Internal Revenue Code on three grounds: (1) fostering the proper role between the judiciary and legislature, (2) respecting the detailed rule-like structure of the Code, and (3) promoting certainty and predictability in tax planning).

¹¹⁸ Literalism today is advanced under the label of "Textualism" by Justice Antonin Scalia and others. See generally Lavoie, *supra* note 107, at 118 (arguing that a judicial embrace of Textualism fosters unethical business behavior by denying that law its ethical base). Although Scalia's Textualism seems consistent with a jurisprudence of PLF, it is but one manifestation of the jurisprudential view and does not define the approach.

¹¹⁹ See generally EDWARD H. LEVI, AN INTRODUCTION TO LEGAL REASONING (1949) (discussing the methods of statutory construction).

¹²⁰ See Yule Kim, Cong. Research Serv., 97-589, Statutory Interpretation: General Principles and Recent Trends 39 (2008), available at <http://www.fas.org/sgp/crs/misc/97-589.pdf> (citing conflicting precedents and concluding that the plain meaning rule "may have been honored more in the breach than in its observance").

¹²¹ Robert Thornton Smith espouses a legislative-purpose-driven approach consistent with PLF. See Robert Thornton Smith, *Interpreting the Internal Revenue Code: A Tax Jurisprudence*, 72 TAXES 527 (1994). Smith's approach to statutory interpretation is inspired by, or at least commonly attributed to, Ronald Dworkin, whom Smith frequently cites. Pursuant to Dworkin's "chain-novel" approach to interpretation, see RONALD DWORIN, LAW'S EMPIRE (1986), the judge may properly be viewed as an author of the statute that is being interpreted, albeit an author who owes special deference to the legislative drafters as coauthors. Other scholars have articulated a similar view. See, e.g., Deborah A. Geier, *Interpreting Tax Legislation: The Role of Purpose*, 2 FLA. TAX REV. 492 (1995) (offering a jurisprudential view similar to Smith and Dworkin); Deborah A. Geier, *Textualism and Tax Cases*, 66 TEMP. L. REV. 445 (1993) (same); Lawrence Zelenak, *Thinking About Nonliteral Interpretation of the Internal Revenue Code*, 64 N.C. L. REV. 623 (1986) (same).

¹²² See Bankman, *supra* note 81, at 11.

ineffective, then an alternative jurisprudential view may be needed. To offer this critique, however, one needs to examine the empirical consequences generated by the dominate view. Ironically, PLF denies the relevancy of such an assessment. The assessment requires a more pragmatic and open-ended approach.

2. Legal Pragmatism

A pragmatic jurisprudence opens the inquiry to empirical matters.¹²³ Pragmatically oriented courts resolve legal ambiguity, for example a dispute over an ATA doctrine like the business purpose rule, with reference to the likely consequences of the decision. Deference to prior interpretations generates value by providing stability and lending a degree of predictability that facilitates business planning, but other values are recognized as well.¹²⁴ Legal pragmatism employs a distinctively instrumental logic, using the language of ends and means while recognizing that ends are tentatively held and that means are discovered and adapted through experimentation.¹²⁵ If a given interpretation of law generates poor results, the rule is changed, and the consequences are measured. The process takes on an organic quality with decisions ever evolving both as to ends and means.¹²⁶

Applying pragmatic reasoning to tax law, one begins with the twin ends of the tax system: legality and fairness.¹²⁷ Legality refers for the need for predictability in law. A tax law that is interpreted without reference to idiosyncratic moral or political concerns of the judge provides a bulwark against government usurpation of private property. Thus, legality provides legitimacy to judicial decisions. Yet, the interpretation of the tax law, or system of tax laws, must also be perceived by taxpayers as being materially fair.¹²⁸ If unilateral adherence to legality produces a significant tax gap generated through manipulations of step transactions and international tax havens, or a tax gap favoring one class of taxpayer over another, then something needs to be changed.¹²⁹

A pragmatically oriented court would seek to balance legality with fairness.¹³⁰ For example, a fairness-minded court may be inclined to cooperate with the legislative branch by providing a robust set of ATA doctrines. Depending on context, these doctrines may be advanced through the common law process, by interpretation of the ever-increasing instances of legislatively created ATA initiatives,¹³¹ or by simply interpreting existing tax

¹²³ See generally Symposium, *The Revival of Pragmatism*, 18 CARDOZO L. REV. 1 (1996) (offering complementary but distinct views of pragmatic legal philosophy); Symposium, *The Renaissance of Pragmatism in American Legal Thought*, 63 S. CAL. L. REV. 1569 (1990) (same).

¹²⁴ See RICHARD A. POSNER, *THE PROBLEMS OF JURISPRUDENCE* 259-60 (1990) (identifying legal stability as one among many competing concerns).

¹²⁵ See Steven D. Smith, *The Pursuit of Pragmatism*, 100 YALE L.J. 409, 444-49 (1990) (noting that under pragmatism both the ends sought and the means employed to achieve those ends continually evolve).

¹²⁶ See RICHARD A. POSNER, *OVERCOMING LAW* 4-15 (1995) (describing the pragmatic method).

¹²⁷ See Michael Livingston, *Practical Reason, "Purposivism," and the Interpretation of Tax Statutes*, 51 TAX L. REV. 677 (1996). Livingston's interpretive philosophy draws on the pragmatic, practical approach associated with Eskridge and Frickey. Under that approach, the mode of interpretation varies from case to case, depending on the statute's age, its legislative history, and the policy issues involved. See WILLIAM N. ESKRIDGE, JR. & PHILIP P. FRICKEY, *CASES AND MATERIALS ON LEGISLATION* 603-04 (2d ed. 1995); William N. Eskridge, Jr. & Philip P. Frickey, *Statutory Interpretation As Practical Reasoning*, 42 STAN. L. REV. 321 (1990).

¹²⁸ See Kovach, *supra* note 104, at 275 (emphasizing the need for a perception of fairness given the voluntary compliance nature of the tax system).

¹²⁹ *Id.* at 275-79 (explaining that a tax system replete with tax haven abuses erodes taxpayer willingness to comply with tax law and thereby increases instances of tax evasion).

¹³⁰ See generally Robert A. Green, *Justice Blackmun's Federal Tax Jurisprudence*, 26 HASTINGS CONST. L.Q. 109 (1998) (exploring an open-ended and non-literal approach to tax law). With reference to the tax jurisprudence of Justice Blackmun, Robert Green notes that Blackmun's "approach does not rely exclusively on any single touchstone for interpretation. Rather, it relies on multiple arguments that draw on a broad range of evidence and considerations: the statutory text, legislative history, legislative purpose, post-enactment developments (including judicial and administrative precedents), and the practical consequences of alternative interpretations." *Id.* at 130.

¹³¹ See Libin, *supra* note 79, at 346 n.40 (noting that the Health Care and Education Reconciliation Act of 2010 added I.R.C. §7701(o) which is essentially codified the economic substance doctrine). Legislatures in several countries, including Canada and Australia, have enacted general anti-avoidance rules, sometimes referred to under the acronym GAAR. *Id.* at 351 n.64. Libin proposes similar legislation in the United States. *Id.* at 351; see also Judith Freedman, *Defining Taxpayer Responsibility: In Support of a General Anti-Avoidance Principle*, 4 BRITISH TAX REV. 332 (2004). Freedman argues for a legislative ATA principle in the United Kingdom as a way to

regulations with reference to the needs of public policy. If a pragmatically oriented court perceived income distribution as a societal problem, for example, it could use that perception to broaden its interpretation of ATA doctrines as a means of addressing the matter. Literal interpretations of statutes and precedents would play a subsidiary role. The pragmatic court becomes a partner in policy matters with the legislature, rather than a mere automaton mechanically interpreting formal law.

Although legal pragmatism has its virtues, it also has its limitations. First, an empirically-oriented court can be hamstrung by a lack of data.¹³² The court may want to interpret law so as to promote good consequences, but how are those consequences to be measured.¹³³ Second, shifts in public policy can generate confusion among taxpayers and tax planners, thereby increasing transaction costs.¹³⁴ Finally, Richard Posner, a leading proponent of legal pragmatism, describes pragmatic reasoning as a "grab bag that includes anecdote, introspection, imagination, common sense, custom, memory, experience, intuition, and induction."¹³⁵ Posner's description raises the concern that pragmatism may be so open-ended that judges may have difficulty in removing their own preconceptions and predilections from their opinions.

C. Summary

It would seem that whether the limitations of pragmatism are counterbalanced by its virtues can only be judged with reference to specific cases. Courts have access to ATA doctrines with which to address tax avoidance schemes. Pragmatism, with its appeal to empirical consequences, asks the courts to use the doctrines aggressively. PLF, by contrast, would seem to limit their use.

The following case study, drawn from the global community, illustrates the jurisprudential debate. It examines a tax controversy currently working its way through Swedish courts. The controversy involves a literal interpretation of Swedish tax law that suggests that interest earned on certain "intra-group loans" is deductible by the debtor and taxable to the lender even if there is no business purpose for the loans other than to reduce cumulative taxes. Critics contend that this literal interpretation generates as an unintended and unfair tax shelter, and they are asking the courts to declare the practice illegal. The question for the Swedish courts is whether a pragmatic jurisprudence can incorporate an appeal to fairness without unduly harming a commitment to legality that promises to safeguard the rule of law.

IV. INTRA-GROUP LOANS

Sweden has a long-standing tradition of literal, or potentially hyper-literal, interpretations of tax law.¹³⁶ This tradition permeates Swedish tax planning, tax-court opinions, and academic commentary. The tradition also encourages step transactions and similar tax-planning tactics that reduce the Swedish tax base. Reflecting this concern, the Swedish legislature recently enacted ATA provisions explicitly inviting tax courts to regulate overly aggressive and self-serving interpretations of law. A pragmatic, results-oriented interpretation of the new ATA legislation could cause a marked change in Swedish tax practice. Yet, a jurisprudential shift from a hyper-literal interpretation of the tax code that permits aggressive tax planning toward a more pragmatic jurisprudence that

legitimize judicial efforts to address tax avoidance, *id.* at 333, and cites New Zealand's Tax Administrative Act of 1994 as an example of a broadly-worded GAAR. *Id.* at 355 n.129.

¹³² See Weisbach, *supra* note 76, at 242 (noting that the extent of tax shelter abuse is difficult to measure because of the deceptive and secretive nature of shelters).

¹³³ See Stetson, et al., *supra* note 36, at 361-62.

¹³⁴ Beth Stetson criticizes the pragmatic, public-policy approach to tax interpretation associated with Judge Richard Posner and the Seventh Circuit. *Id.* Stetson argues that the "lack of deference to Regulation 1.162-7 in favor of Law and Economics theory is not legally proper. Because taxpayers' trust in and deference to Treasury Regulations is grounded in the expectation that courts will follow them, such judicial refusal to follow Treasury regulations may have negative consequences." *Id.* at 361.

¹³⁵ POSNER, *supra* note 109, at 73.

¹³⁶ See generally Mats Tjernberg, *Regeringsrättens Strikta Lagtolkning*, in SKATTENYTT 14 (2003) (arguing for a literal interpretation and citing the Supreme Administrative Court in support); Peter Melz, *Swedish National Report*, in COMPARATIVE INCOME TAXATION 129, 138 (Hugh J. Ault & Brian J. Arnold ed., 3d ed. 2010) (noting a tendency to literal interpretation of statutes in the Supreme Administrative Court); SVEN-OLOF LODIN ET. AL, INKOMSTSKATT 719-34 (2015) (presenting literal interpretation as the predominant and preferred method, in contrast to "free interpretation" (cp. legal pragmatism), which is referred to as a threat to legal certainty).

discourages it, will not come easy. The following sections illustrate the Swedish experience on this matter in relation to one of the most popular and effective tax planning schemes for multinational companies: interest deductions on intra-group loans.

A. *The Specific Tactic*

A country's income tax revenues derive from production in that country. Over the last decade, many countries, including Sweden, witnessed a substantial decrease in tax revenues due to practices that artificially shifted taxable income from the country where it was produced to a country where the income is subject to more favorable tax treatment.¹³⁷ A relatively simple and widely used tactic involves interest deductions on intra-group loans. A foreign, related company loans money to a producing company. The producing company uses the income from production to pay interest on the loan. The interest expense is deducted from income in the producing country and reported as income in the foreign venue.¹³⁸ The investment group chooses a venue for the loaning company that offers no, or very low taxes on the distributed income: hence, the group greatly reduces its overall tax burden.¹³⁹

This profit-shifting technique has resulted in considerable tax-base erosions in several OECD countries and has become a significant public-policy concern.¹⁴⁰ Considerable amounts previously used to finance schools, health care, and other public goods in the producing countries gets distributed directly to the owners of the companies located in the low tax regimes. This situation ultimately harms individuals and businesses that are not able to conduct such tax planning as they eventually have to bear a greater share of the financing of public good.¹⁴¹ As a result, legal measures against aggressive tax planning through interest deductions on intra-group loans are being dealt with on the national level, within the European Union,¹⁴² and by the OECD.¹⁴³

B. *Legislative Reforms*

The exploitation of inter-group loans to transfer of income among related companies has a fairly lengthy history in Sweden. The Swedish Parliament recently enacted with two generations of ATA reforms. The first addresses tax avoidance schemes generally; the second is specifically aimed at the intra-group loan tactic. The following sub-sections discuss the initial judicial reluctance to address the intra-group loan strategy prior to the recent reforms and then examine the recent legislative reforms.

1. Traditional Approach to Intra-Group Loans

Swedish tax courts have been reluctant to use ATA principles to address inter-group loans. For example, in 1990, the Swedish Supreme Administrative Court (SAC) held that without explicit "thin capitalization rules," it was not possible to reclassify debt to equity, and in that way dismiss interest deductions, in a heavily leveraged Swedish subsidiary that allegedly paid extensive amounts of interest to its U.S. parent company.¹⁴⁴ The SAC reasoned that in situations where the interpretation of tax law relies on private law – in the classification of debt and equity for

¹³⁷ In a report presented to the Swedish Government, the Swedish Tax Agency estimated the revenue loss in 2012 as more than five percent (approximately five billion SEK) of the entire corporate income tax revenues; Swedish Tax Agency, Report 131 756251-13/113, January 20, 2014.

¹³⁸ See, e.g., RAFFAELE RUSSO ET.AL., FUNDAMENTALS OF INTERNATIONAL TAX PLANNING 107-16 (2007).

¹³⁹ Tax shelters unveiled in the "Luxembourg Leaks" exemplifies such situations. See THE INTERNATIONAL CONSORTIUM OF INVESTIGATIVE JOURNALISTS, ICIJ, LUXEMBOURG LEAKS: GLOBAL COMPANIES' SECRETS EXPOSED at <http://www.icij.org/project/luxembourg-leaks> (last visited May 22, 2015).

¹⁴⁰ See Kirsten Burmester & Safford Smiley, *Overview of the OECD's Action plan on Base Erosion and Profit Shifting*, 40(6) J. CORP TAX'N 49 (2013).

¹⁴¹ See, e.g., *id* (discussing the 2013 OECD Action Plan on Base Erosion and Profit Shifting).

¹⁴² Communication from the Commission to the European Parliament and the Council on concrete ways to reinforce the fight against tax fraud and tax evasion including in relation to third countries, COM (2012) 351 final (June 27, 2012).

¹⁴³ *Id.* at 145, and OECD, Public Discussion Draft, BEPS Action 4: Interest Deductions and Other Financial Payments, 18 December 2014 - 16 February 2015 (2014); see also Benn Folkvord & Michael Riis Jacobsen, *Corporate Income Tax and the International Challenge*, NORDIC TAX J. 55 (2014) (reviewing legal measures against aggressive international tax planning in the Nordic countries).

¹⁴⁴ Regeringsrättens årsbok[RÅ] [Supreme Administrative Court] 1990-04-11 ref 34 (Swed.).

example – a valid, private-law classification cannot be dismissed with reference to general substance-over-form arguments.¹⁴⁵ A similar reluctance to use ATA principles can be seen in cases from 2001 and 2007 wherein the SAC ruled that general ATA arguments¹⁴⁶ were not applicable on interest-deduction strategies carried out in company groups led by Swedish tax exempt persons such as municipalities¹⁴⁷ and investments companies.¹⁴⁸ In each case, the courts chose to limit ATA principles rather than to expand them.

More recently, in a 2010 decision, the SAC decided that the interest rate on a debt instrument between two Swedish companies – one wholly owned subsidiary and its tax exempt parent company – should be lower than the interest on a corresponding debt instrument between unrelated parties.¹⁴⁹ The SAC reasoned that the control a parent company has in its wholly owned subsidiary reduces the credit risk; thus, the interest rate between related parties should be less than between unrelated parties. This line of argumentation, however, has not gained ground in cross-border situations. In such situations the internationally accepted "arm's length principle" requires that interest rates on debt instruments between related parties shall be decided only with reference to corresponding instruments agreed between unrelated parties under market conditions.¹⁵⁰ Hence, the exploitation of interest deductions on inter-group loans persists in international contexts.

2. Two Generations of Legislation

In 2008, the Swedish Tax Agency released tax audits on Swedish multinational enterprises demonstrating substantial tax-base erosion due to step transactions with intra-group interest deductions and the shifting of income to international tax havens.¹⁵¹ The Swedish Parliament responded with a set of rules limiting interest deductions on intra-group loans in 2009 and a second set of rules in 2013.¹⁵² The first generation of reforms denied deductions on interest paid to related companies unless the foreign creditor was taxed at a "ten-percent minimum" (ten-percent rule). It also denied the deduction if the loan did not have a "true business purpose" (TBP test).¹⁵³

Second generation reforms provided that the true business purpose of an inter-company debt obligation always must be considered in relation to the possibility of distributing the capital in terms of equity instead of debt (the distribution rule). In addition, the second generation clarified that the ten-percent rule was intended to exclude interest paid on debt where the main purpose was to give the company group a substantial tax benefit.¹⁵⁴ Taken collectively, the two generations of legislation provided the tax courts with a robust framework with which to address excesses associated with intra-group loans.

¹⁴⁵ *Id.*

¹⁴⁶ Lag mot skatteflykt (Svensk förtattningssamling [SFS]1995:575) (Swed.).

¹⁴⁷ Regeringsrättens årsbok [RÅ] [Supreme Administrative Court] 2001-12-19 ref 79 (Swed.).

¹⁴⁸ Regeringsrättens årsbok [RÅ] [Supreme Administrative Court] 2007-10-03 ref 85 (Swed.). Because the reduction of tax expenses primarily was the consequence of the creditors' legal status as tax exempt subjects, the outcome of these strategies – reduced tax – could not be considered in conflict with the purpose of the law, which is a requirement in order for the general anti-avoidance rule (GAAR) to be applicable. *Id.* at 151.

¹⁴⁹ Regeringsrättens årsbok [RÅ] [Supreme Administrative Court] 2010-06-28 ref 67 (Swed.).

¹⁵⁰ OECD, TRANSFER PRICING GUIDELINES FOR MULTINATIONAL ENTERPRISES AND TAX ADMINISTRATIONS (2010). The interest rate levels on inbound-debt financing would not seriously threaten the Swedish tax base if Sweden could apply withholding taxes on the outbound interest payments. For reason of attracting foreign capital, Sweden has since long chosen not to have such taxation. See Lars Jonsson & Peter Melz, *Swedish National Report, in* CAHIERS DE DROIT FISCAL INTERNATIONAL, NEW TENDENCIES IN TAX TREATMENT OF CROSS-BORDER INTEREST OF CORPORATIONS (Vol 93b2008).

¹⁵¹ Swedish Tax Agency, Förslag om begränsningar i avdragsrätten för ränta m.m. på vissa skulder, Dnr. 131-348803-08/113 2008-06-23.

¹⁵² Swedish Tax Agency, Ränteavdrag i företagssektorn, Dnr. 131-890752-09/113; 2009-12-14, Swedish Tax Agency, Ränteavdrag i företagssektorn – Fortsatt kartläggning, Dnr. 131-755479-10/113, 2011-03-14,); and Proposition [Prop.] 2012/13:1 Budgetpropositionen för 2013 [government bill] (Swed.). See also Swedish Tax Agency, Skatteplanering med ränteavdrag i företagssektorn - Externa lån och nya metoder för kringgåenden av 2009 års lagstiftning, Dnr. 131 756251-13/113 2014-01-20.

¹⁵³ Inkomstskattelag [IL] [Income Tax Act] 24:10e (Swed.).

¹⁵⁴ For example, intra-group debt obligations with the creditor domiciled in a "high tax country" (e.g. Germany or Norway) may have a tax loss carry-forward that can be used to set off received interest income providing substantial tax benefits for the company group. See Proposition [Prop.] 2012/13:1 Budgetpropositionen för 2013 [government bill] (Swed.) 253-54.

Critics have challenged the recent legislation on at least three grounds. First, many taxpayers and tax advisors challenge the propriety of imprecise legislative terms such as “true business purpose.”¹⁵⁵ These critics contend that vague terms frustrate business planning. Second, some legal scholars have criticized the Swedish legislation in relation to European Union (EU) primary law. The criticism emphasizes the vagueness of certain terms which allegedly violate the EU principle of proportionality that is superior any national legislation of EU Member States, including Sweden.¹⁵⁶ Finally, the limitation rules have been criticized as threatening the Swedish income tax base. In particular, the Confederation of Swedish Enterprise (CSE) argues that these rules will potentially cause less inbound investments, which results in less production, and therefore reduces tax revenues on wages and consumption.¹⁵⁷

The notion of a *true business purpose* resides at the center of the recent reforms. Preparatory works associated with the legislation suggest that the term is to be interpreted narrowly.¹⁵⁸ In particular, pursuant to the preparatory works, taking acts solely to reduce one's tax does *not* constitute a true business purpose.¹⁵⁹ This is why “true” is used as a prerequisite to this general ATA doctrine.¹⁶⁰ In essence, the new legislation provides the Swedish Tax Courts with a general ATA provision akin to the business purpose doctrine developed in U.S. common law.¹⁶¹ This general ATA rule was enacted in 2009 and then made specifically applicable to intra-group-loans in 2013.

C. Judicial Response

Controversies regarding the proper interpretation of the TBP test as applied to inter-group loans are appearing in Swedish tax courts. The SAC, for example, recently ruled that intra-group reorganizations solely for tax reasons did not constitute a true business purpose.¹⁶² Critics, including a dissenting voice on the SAC, contend that the *general meaning* of the term business purpose includes re-organizations and that it violates principles of statutory interpretation to ignore general meanings.¹⁶³ Critics also contend that reducing one's tax should be considered a true business purpose.¹⁶⁴ However, parliamentary preparatory works associated with the recent reforms, explicitly state that tax expenses shall *not* be considered when the purpose of a transaction is established.¹⁶⁵

¹⁵⁵ See, e.g., Anita Zester, *Affärsmässiga skäl – vad är innebörden?*, in SKATTENYTT 261 (2009); Lars Samuelsson, *Regeringens slutliga förslag om effektivare ränteavdragsbegränsningar*, in SKATTENYTT, 820 (2012); Carina Terenius Jilkén & Daniel Jilkén, *Väsentligt inflytande och under huvudsak gemensam ledning – luddiga begrepp på drift?*, in SVENSK SKATTETIDNING 492 (2013).

¹⁵⁶ See, e.g., Fredrik Ohlsson, *Ränteavdragen och EU-rätten*, SKATTENYTT, 11 (2014); Mattias Dahlberg, Board for Advanced Tax Ruling, 2014-12-09 108-13/D (Swed.) (divergent opinion); see also European Commission's Formal Notice C(2014) 8699 Final. For arguments in the opposite see, for example, Maria Hilling *Justifications and Proportionality: An Analysis of the ECJ's Assessment of National Rules for the Prevention of Tax Avoidance*, INTERTAX 294 (2013); and the majority's opinion in Skatterättsnämnden [SRN] [Board for Advanced Tax Ruling] 2014-12-09 108-13/D (Swed.).

¹⁵⁷ Krister Andersson, *Räntesnurror, gungor och karuseller*, SVENSK SKATTETIDNING, 289 (2009).

¹⁵⁸ Proposition [Prop.] 2008/09:65 Sänkt bolagsskatt och vissa andra skatteåtgärder för företag [government bill] (Swed.)68.

¹⁵⁹ Proposition [Prop.] 2008/09:65 Sänkt bolagsskatt och vissa andra skatteåtgärder för företag [government bill] (Swed.) 66-69.

¹⁶⁰ Proposition [Prop.] 2008/09:65 Sänkt bolagsskatt och vissa andra skatteåtgärder för företag [government bill] (Swed.) 68.

¹⁶¹ See *supra*, Part III.A (discussing the U.S. ATA doctrines). Critics notes that the Swedish word for “true” refers to a quantity of seventy five percent. One cannot establish a specific quantity of something that cannot be measured by quantity – the purpose of a business transaction; hence, the “true business purpose” must be interpreted on a qualitative basis, irrespective of the statements in relevant preparatory works. See, e.g., Robert. Pålsson, R. in his divergent opinion in Skatterättsnämnden [SRN] [Board for Advanced Tax Ruling] 2010-06-24 160-09/D (Swed.).

¹⁶² Högsta förvaltningsdomstolen, [HFD] [Supreme Administrative Court] 2011-11-30 RÅ 2011 ref 90 (Swed.).

¹⁶³ See, e.g., Lars Samuelsson, *HFD om räntesnurrorna – klargörande om en lagstiftning i förvandling*, SKATTENYTT, 136 (2012); Thomas Andersson & Christian Carneborn, *HFD:s domar den 30 november 2011 avseende ränteavdragsbegränsningsreglerna – en kommentar*, SVENSK SKATTETIDNING, 54 (2012); and Anders Hultqvist, *Affärsmässigt motiverad – en analys av bestämmelserna om ränta på koncerninterna lån*, SVENSK SKATTETIDNING, 122 (2012).

¹⁶⁴ See, e.g., Anita Zester, A., *Affärsmässiga skäl – vad är innebörden?*, SKATTENYTT, 261 (2009).

¹⁶⁵ *Id.*

Although the legislature questioned the suitability of the term "true business purpose" to exclude tax driven actions, the statutory language remained unchanged.

1. Board for Advance Tax Rulings

In 2014, the Swedish Board for Advanced Tax Ruling (Board) applied the TBP test to five cases involving intra-groups loans. In each case, the Board drew heavily upon preparatory works.¹⁶⁶ Those works specify that when the true business purpose of an intra-group loan is challenged, attention should focus on whether the loan could be replaced by an equity contribution ("contribution rule").¹⁶⁷ If an equity contribution could replace the loan then the loan lacks a true business purpose.¹⁶⁸ Applying this rule to the five cases, the Board held that each loan failed the TBP test and denied the interest deductions. Taxpayer advocates greatly dislike these decisions. Drawing on constitutional principle of legality they argue that vaguely written preparatory works have had too great an influence in the interpretation and application of the law.¹⁶⁹

2. Supreme Administrative Court

To establish a citable precedent under Swedish law, questions answered by the Board must be appealed to the SAC. Each of the above five Board decisions has been appealed. Somewhat surprisingly, the SAC refused to address questions pertaining to the interpretation of the TBP test as used in the limitation rules.¹⁷⁰ The court cited "distinctive investigative issues" that make the cases improper for precedential status. Although the preparatory works to the legislation set forth circumstances that could aid judicial interpretation,¹⁷¹ the SAC argued that the interpretation suggested in the preparatory works would require comprehensive investigations of idiosyncratic circumstances in every case. The circumstances to which any precedent would apply would therefore be very specific rendering the cases of limited value for the general understanding of the relevant legislation. The SAC refused to engage in such deliberations.

The SAC's failure to provide guidance seems somewhat odd. Several of the cases lack complexity, so nuanced factual inquiries seem unnecessary. For example, in *Växjö Municipality*, the relevant question was whether an intra-group loan had a true business purpose.¹⁷² The municipality argued that the loan to its subsidiary had a true business purpose because a loan is less expensive to govern compared to a distribution of capital which would involve more costly administrative and regulatory measures. On appeal, the SAC was asked to decide whether extra administrative and regulatory expenses are sufficient reasons to classify a loan as having a true business purpose in situations where the creditor has a possibility to make a capital distribution instead of the loan. This appears to be a

¹⁶⁶ Skatterättsnämnden [SRN] [Board for Advanced Tax Ruling] 2014-04-1638-13/Dand 71-13/D; 2014-05-26 74-13/D; 2014-07-09 117-13/D, and 2014-10-06 132-13/D (Swed.). The Board is an agency under the Ministry of Finance that announces binding advance rulings on tax issues.

¹⁶⁷ Inkomstskattelag [IL] [Income Tax Act] 24:10e (Swed.).

¹⁶⁸ Proposition [Prop.] 2012/13:1 Budgetpropositionen för 2013 [government bill] (Swed.) Prop. 2012/13:1 pp. 254-265.

¹⁶⁹ See, e.g., Anders Hultqvist, *Förhandsbesked om ränteavdragsbegränsningen*, BLENDOW LEXNOVA EXPERTKOMMENTAR – SKATTRÄTT (2014), available at

http://www.hultqvist.se/artiklar/Lexnova_maj_2014_SRN_ranteavdragen.pdf; see also Anders Hultqvist, *Affärsmässigt motiverad – en analys av bestämmelserna om ränta på koncerninterna lån*, SVENSK SKATTETIDNING 122 (2012). Critics also argue that there is a general principle in Swedish income taxation that the business purpose of company's transactions shall, for reason of predictability, not be challenged by the taxing authority: Robert Pålsson in his divergent opinion in Skatterättsnämnden [SRN] [Board for Advanced Tax Ruling] 2010-06-24 160-09/D (Swed.). The basis for this line of argumentation is not very strong because it is confined to submissions in a previous decision from the Supreme Administrative Court and on preparatory works to other tax law. Regeringsrätten årsbok [RÅ] [Supreme Administrative Court] 200004-28 ref 21 (Swed.) and Proposition [Prop.] 1998/99:15 Omstruktureringar och beskattning [government bill] (Swed.) 137.

¹⁷⁰ Högsta förvaltningsdomstolen [HFD] [Supreme Administrative Court] 2014-12-23 2674-14 (Swed.); Högsta förvaltningsdomstolen [HFD] [Supreme Administrative Court] 2015-02-23 2706-14, 3853-14, 4201-14, 4217-14, 5837-14, and 6634-14 (Swed.).

¹⁷¹ See Proposition [Prop.] 2012/13:1 Budgetpropositionen för 2013 [government bill] (Swed.) 253-265.

¹⁷² Skatterättsnämnden [SRN] [Board for Advanced Tax Ruling] 2014-04-16 38-13/D (Swed.).

question of general relevance and seems well suited for precedence decision. The SAC, however, found this question too specific to be suited for precedence decisions.

The SAC's resistance to deal with cases in which the true business purpose of an intra-group loan is to be established is troublesome. Aggressive tax planning with step transactions erodes the Swedish tax base and hyper-literal interpretation of tax law facilitates overly aggressive tax planning through such tactics as intra-group loans combined with exploitation of global-tax havens. To fight overly aggressive tax planning, the Swedish Parliament enacted broadly worded anti-avoidance legislation inviting the courts to examine the true business purpose of a given action. Yet, the SAC finds this legislation, whose application requires investigations of idiosyncratic circumstances, overly vague and thus far has refused to provide precedence guidance. Due to the lack of precedence guidance the impact of the anti-avoidance legislation remains in doubt. Step transactions that erode the Swedish income tax base can continue to flourish. In short, the SAC insistence on hyper-literal interpretations resides at the root of the problem. ATA legislation, by its very nature, is broadly worded and invites judicial discretion. Refusing to rule on the grounds that the legislation is too vague, hampers legislative attempts to deal with tax planning abuses.

D. Reflections

Swedish courts and taxing authorities have a new legislative ATA tool with which to fight aggressive tax shelters. The effectiveness of this tool will depend on the jurisprudential attitude of the courts and taxing authorities. A pragmatic approach to legal interpretation presupposes that courts play an active role in the public policy arena.¹⁷³ It invites the court to consider the social fairness norms that support voluntary compliance with tax law.¹⁷⁴ It also embraces empirical and nuanced judicial inquiries into idiosyncratic facts.¹⁷⁵ Recent Board decisions show a willingness to use the TBP test to reign in excesses in tax planning. A pragmatic embrace of the TBP test would exclude tax-driven transactions such as intra-group reorganizations¹⁷⁶ and debt transactions that could be replaced by equity contributions.¹⁷⁷ Unfortunately, the SAC has yet to fully embrace the new jurisprudence.

Swedish tax planners and critics of the new ATA legislation continue to express a strong preference for hyper-literal interpretations of tax law. Though unlikely to use the term, these planners and critics are expressing a jurisprudence of positive, legal formalism.¹⁷⁸ Positivism facilitates aggressive tax planning, in part, by excluding ethical considerations in the interpretation of the law.¹⁷⁹ Formalism excludes consideration of the empirical threats posed by global tax shelters.¹⁸⁰ Planners and critics argue that interpretation of a tax language should be limited to the ordinary meaning of the words used in the statute or regulation without reference of how those words are defined in the preparatory works.¹⁸¹ To reason otherwise, they contend, conflicts with the constitutional principle of legality.¹⁸²

Legal pragmatism, by contrast, offers a means of safeguarding the underlying values of the tax system, including due respect for both *legality* and *fairness*. The Board seems to have embraced the pragmatic approach. Perhaps the resistance of the SAC to deal with the appealed cases will lead the Swedish Parliament to abandon the

¹⁷³ See *infra* Part III.B.2 (outlining the contours of legal pragmatism as applied to tax controversies).

¹⁷⁴ See *id.*

¹⁷⁵ See *id.*

¹⁷⁶ Proposition [Prop.] 2008/09:65 Sänkt bolagsskatt och vissa andra skatteåtgärder för företag [government bill] (Swed.) 87-88, and Högsta förvaltningsdomstolen [HFD] [Supreme Administrative Court] 2011-11-30 ref. 90 (Swed.).

¹⁷⁷ Proposition [Prop.] 2012/13:1 Budgetpropositionen för 2013 [government bill] (Swed.) 254-265, and Skatterättsnämnden [SRN] [Board for Advanced Tax Ruling] 2014-04-16, decisions 38-13/D, and 71-13/D; 2014-05-26, 74-13/D; 2014-07-09, 117-13/D, and 2014-10-06 132-13/D (Swed.).

¹⁷⁸ See *infra* Part III.B.1. (defining and discussing a jurisprudence of positive, legal formalism in the light of tax law).

¹⁷⁹ See *id.*

¹⁸⁰ See *id.*

¹⁸¹ See, e.g., Anders Hultqvist, *Affärsmässigt motiverad – en analys av bestämmelserna om ränta på koncerninterna lån*, SVENSK SKATTETIDNING, 122 (2012).

¹⁸² Anders Hultqvist, *Förhandsbesked om ränteaavdragsbegränsningen*, BLENDOW LEXNOVA EXPERTKOMMENTAR – SKATTRÄTT, (2014), http://www.hultqvist.se/artiklar/Lexnova_maj_2014_SRN_ranteavdragen.pdf.

criticized avoidance rules.¹⁸³ An alternative solution to the challenges posed by tax-base erosion and profit shifting may be to rewrite the corporate income tax system in a way that effectively deals with unwanted step transactions and tax havens without relying on pragmatic interpretations of tax law. Perhaps such a system could be drafted in a language that lacks tax terminology and uses terminology that has a general meaning outside the tax system.¹⁸⁴ One can only speculate on whether such drastic measures would satisfy Swedish tax payers and their planners. At times it seems that the critics simply want to avoid paying taxes without breaking the law.

V. Conclusion

Maldistribution of income and wealth presents a growing concern throughout the developed world. This is particularly true in the United States, and of increasing concern in Scandinavia and elsewhere. Perhaps no contemporary economic issue appears more important. In addition, both the size and scope of tax avoidance behaviors, particularly through international tax havens, seem staggering. The two issues, maldistribution of income and tax avoidance, are interrelated, as wealthy people use tax havens; working class people do not. To address the matter, public-policy makers need international cooperation. There also needs to be cooperation between legislative and judicial branches in host nations.

This article seeks to advance discussion of this topic with particular emphasis on the jurisprudential views of the judiciary. Hyper-literal interpretations of the tax code encourage tax avoidance schemes. A result oriented, public-policy approach to legal interpretation can discourage them. The ongoing Swedish experience with step transactions and legislative reforms illustrate some of the economic, cultural, and political impediments to necessary reforms. The path will not be easy.

Policy makers in the United States can learn from the Swedish experience. To effectively eradicate tax avoidance, or to limit the most abusive practices, requires cooperation between the legislature, taxing authorities, and the judiciary. The Swedish case study shows the frustration generated when a court insists on a formal approach to tax jurisprudence. In addition, Swedish courts can learn from the pragmatic approaches to law employed by some U.S. courts, including tax courts. The U.S. experience illustrates that respect for the rule of law can be maintained even when the courts make pragmatic inquiries into public policy.

¹⁸³ The SAC's opposition to the anti-avoidance rules is discouraging for the Government ambition to justify the regulations in relation to EU law.

¹⁸⁴ In June 2014, the Swedish Government Committee on Corporate Taxation presented an alternative corporate income tax system that effectively prevents excessive intra-group interest deductions. The intent is to use terminology that leaves little room for a systematic interpretation in relation to the underlying values of the tax system. See Statens Offentliga Utredningar [SOU] 2014:40, *Neutral bolagsskatt – för ökad effektivitet och stabilitet* [government report series] (Swed.). The alternative system is reviewed in: S-O Lodin, *An overview of the Proposal of the Swedish Government Committee on Corporate Taxation*, NORDIC TAX J. 43 (2014), and commented on in: Axel Hilling, *Skatterätt eller finansiell ekonomi? - klassificeringsfrågor med anledning av Företagsskattekommitténs slutbetänkande*, SVENSK SKATTETIDNING 179 (2015). Interestingly, this proposed system largely satisfies the criticism of today's anti-avoidance rules; nevertheless, tax payers and tax advisers seem to dislike the proposed rules as much as today's rules. The new criticism does not focus on vague terminology; rather, the proposed regulation is disliked because it: (1) is dissimilar to equivalent systems used in other countries such as earning-stripping rules or thin-capitalization rules; (2) would cause extra administrative costs; (3) should not be implemented before the OECD's BEPS-project is completed; and (4) disfavors certain groups of companies. See Johanna Lundqvist et al., *Remissutfallet på Företagsskattekommitténs slutbetänkande "Neutral bolagsskatt – för ökad effektivitet och stabilitet"* (SOU 2014:40), SKATTENYTT 32 (2015)(summarizing opinions from remittance instances).