Catholic University Law Review

Volume 61
Issue 4 *Summer 2012*

Article 3

2012

Rethinking the Timing of Tax Decisions: Does a Taxpayer Ever Deserve a Second Chance?

Emily Cauble

Rethinking the Timing of Tax Decisions: Does a Taxpayer Ever Deserve a Second Chance?

Cover Page Footnote

Assistant Professor, Michigan State University College of Law. The author would like to thank Adam Candeub, Jennifer Carter-Johnson, Jerold Friedland, Steven Greenberger, Catherine Grosso, David Hasen, Max Helveston, Michael Jacobs, Calvin Johnson, Richard Kaplan, Mae Kuykendall, Julie Lawton, Gregory Mark, Tanya Marsh, Amy McCormick, Daniel Morales, Larry Ribstein, Michael Sant'Ambrogio, David Thronson, Mark Weber, participants at the 2012 Critical Tax Conference, and participants at the faculty workshop at the University of Toledo College of Law for their valuable comments. The author would also like to thank Robert Chaklos and Andrea Nester for their excellent research assistance.

RETHINKING THE TIMING OF TAX DECISIONS: DOES A TAXPAYER EVER DESERVE A SECOND CHANCE?

Emily Cauble[+]

[+] Assistant Professor, Michigan State University College of Law. The author would like to thank Adam Candeub, Jennifer Carter-Johnson, Jerold Friedland, Steven Greenberger, Catherine Grosso, David Hasen, Max Helveston, Michael Jacobs, Calvin Johnson, Richard Kaplan, Mae Kuykendall, Julie Lawton, Gregory Mark, Tanya Marsh, Amy McCormick, Daniel Morales, Larry Ribstein, Michael Sant'Ambrogio, David Thronson, Mark Weber, participants at the 2012 Critical Tax Conference, and participants at the faculty workshop at the University of Toledo College of Law for their valuable comments. The author would also like to thank Robert Chaklos and Andrea Nester for their excellent research assistance.

When a taxpayer contemplates engaging in a transaction, he or she often will assess the tax consequences of various versions of the transaction, and his or her decisions about whether and how to engage in the transaction will be informed, in part, by the anticipated tax consequences. Designing a transaction in a particular manner to achieve favorable tax consequences is known as tax planning.

Typically, tax-planning decisions must be made before a transaction has begun.[1] In other words, most tax planning consists of "pre-transactional tax decisions." Consequently, tax decisions often occur when the taxpayer lacks complete information about the economic outcome of a transaction. For example, when a taxpayer makes tax-planning decisions regarding a transaction, he or she may predict that the transaction will be profitable but might not know for certain if it will indeed yield any profits. This taxpayer may make tax-planning decisions based on his or her prediction that the transaction will be profitable. If the transaction ultimately generates a loss, the tax-planning decisions made in contemplation of profit may lead to less favorable tax consequences than those that would have resulted from tax planning that was based on an expectation of loss.

"Post-transactional tax decisions" occur after a transaction has commenced. In some cases, a post-transactional tax decision is a response to new information regarding the economic outcome of a transaction.[2] In the example in the preceding paragraph, a post-transactional tax decision would include any step the taxpayer took to achieve more advantageous tax results after learning that the transaction generated a loss. In other cases, a post-transactional tax decision is a reaction to new information about the tax law itself.[3] For example, a taxpayer might not obtain information about applicable tax law in advance of carrying out a transaction and, only after the transaction has begun, the taxpayer may learn that more favorable tax consequences would have resulted had he or she employed more effective pre-transactional tax planning. In this situation, any attempt to alter the tax consequences of the transaction after it has commenced would constitute a post-transactional tax decision. In other situations, a taxpayer may seek to make a post-transactional tax decision when the Internal Revenue Service (IRS) challenges the tax consequences that the taxpayer claims resulted from a completed transaction.[4] In this situation, a post-transactional tax decision consists of any action the taxpayer takes to achieve more favorable tax consequences than those the IRS imposed on the completed transaction.

In contrast to pre-transactional tax decisions that are often allowed,[5] the tax law imposes substantial limitations on post-transactional tax decisions.[6] This

---

1. This is true because of limitations on "post-transactional tax decisions." These limitations are discussed *infra* Part I.

2. For further discussion, *see infra* Part I.B.1.

3. For further discussion, *see infra* Part I.B.2.

4. For further discussion, *see infra* Part I.B.3.

5. The limitations on pre-transactional tax decisions are beyond the scope of this Article. Such limitations include the substance-over-form doctrine, the step transaction doctrine, the economic substance doctrine, and a number of anti-abuse rules applicable to specific areas of tax law. Literature discussing these doctrines and rules is extensive. *See, e.g.*, Ellen P. Aprill, *Tax Shelters, Tax Law, and Morality: Codifying Judicial Doctrines*, 54 SMU L. REV. 9 (2001); Joseph Bankman, *The Economic Substance Doctrine*, 74 S. CAL. L. REV. 5 (2000); Jasper L. Cummings, Jr., *The New Normal: Economic Substance Doctrine First*, 126 TAX NOTES 521 (2010); Hal Gann

Article suggests a number of rationales that may explain the law's hostility towards post-transactional tax decisions. If allowed, these decisions would grant taxpayers more opportunities to tax plan.[7] Further, post-transactional tax decisions may reduce tax liability more effectively than pre-transactional tax decisions because taxpayers would be able to structure their transactions with the benefit of more complete information about the economic consequences of their transactions and about the applicable laws. In other words, post-transactional tax decisions represent a particularly potent type of tax planning. Consequently, general objections to tax planning may merit even greater restrictions on post-transactional tax decisions.

Regarding these general objections, other scholars have criticized tax planning, arguing that it erodes tax revenue and creates unfairness as well as a perception that the tax system is unfair and breeds inefficiency.[8] This Article builds upon existing literature by suggesting that these criticisms help explain the hostility to post-transactional tax decisions. This Article concludes, however, that these objections do not warrant greater restrictions on *all*

& Roy Strowd, *The Recent Evolution of Antiabuse Rules*, 66 TAX NOTES 1189 (1995); Mark P. Gergen, *The Common Knowledge of Tax Abuse*, 54 SMU L. REV. 131 (2001); Daniel J. Glassman, Note, *"It's Not a Lie If You Believe It": Tax Shelters and the Economic Substance Doctrine*, 58 FLA. L. REV. 665 (2006); Daniel Halperin, *Are Anti-Abuse Rules Appropriate?*, 48 TAX LAW. 807 (1995); James S. Halpern, *Putting the Cart Before the Horse: Determining Economic Substance Independent of the Language of the Code*, 30 VA. TAX REV. 327 (2010); David P. Hariton, *Sorting Out the Tangle of Economic Substance*, 52 TAX LAW. 235 (1999) [hereinafter Hariton, *Sorting Out*]; David P. Hariton, *When and How Should the Economic Substance Doctrine Be Applied?*, 60 TAX L. REV. 29 (2006); Joseph Isenberg, *Musings on Form and Substance in Taxation*, 49 U. CHI. L. REV. 859 (1982); Yoram Keinan, *Rethinking the Role of the Judicial Step Transaction Principle and a Proposal for Codification*, 22 AKRON TAX J. 45 (2007); Jeffrey L. Kwall & Kristina Maynard, *Dethroning King Enterprises*, 58 TAX LAW. 1 (2004); Leandra Lederman, *W(h)ither Economic Substance?*, 95 IOWA L. REV. 389 (2010); Allen D. Madison, *Rationalizing the Law by Breaking the Addiction to Economic Substance*, 47 IDAHO L. REV. 441 (2011); Martin J. McMahon Jr., *Economic Substance, Purposive Activity, and Corporate Tax Shelters*, 94 TAX NOTES 1017 (2002); William F. Nelson, *The Limits of Literalism: The Effect of Substance Over Form, Clear Reflection and Business Purpose Considerations On the Proper Interpretation of Subchapter K*, 73 TAXES 641 (1995); Joshua D. Rosenberg, *Tax Avoidance and Income Measurement*, 87 MICH. L. REV. 365 (1988); David M. Schizer, *Frictions as a Constraint on Tax Planning*, 101 COLUM. L. REV. 1312, 1319 (2001); Michael L. Schler, *Ten More Truths About Tax Shelters: The Problem, Possible Solutions, and a Reply to Professor Weisbach*, 55 TAX L. REV. 325 (2002); David J. Shakow, *Consolidated Edison Turns on the Lights*, 126 TAX NOTES 625 (2010); Robert Thornton Smith, *Business Purpose: The Assault upon the Citadel*, 53 TAX LAW. 1 (1999); Lewis R. Steinberg, *Form, Substance, and Directionality in Subchapter C*, 52 TAX LAW. 457 (1999); Steven M. Surdell, *The Emerging Role of Business Purpose in Corporate Tax-Motivated Transactions*, 485 PLI/TAX 683 (2000); Dennis J. Ventry, Jr., *Save the Economic Substance Doctrine from Congress*, 118 TAX NOTES 1405 (2008); David A. Weisbach, *Disrupting the Market for Tax Planning*, 26 VA. TAX. REV. 971 (2007) [hereinafter Weisbach, *Disrupting the Market*]; David A. Weisbach, *Ten Truths About Tax Shelters*, 55 TAX L. REV. 215 (2002) [hereinafter Weisbach, *Ten Truths*].

6. *See infra* Part I.
7. *See infra* Part II.
8. *See infra* Part II.

post-transactional tax decisions.[9] Specifically, although it would be advisable in many cases to abolish a given tax planning opportunity altogether, doing so is not feasible or advisable in some cases. In such cases, restrictions on post-transactional tax decisions should be lessened because limiting post-transactional tax decisions may sometimes intensify the undesirable effects of allowing pre-transactional tax decisions. This is because the post-transactional limitations impart even greater advantages upon taxpayers who plan before a transaction begins.

Finally, tax law is by no means alone in terms of favoring those who plan beforehand. In many areas of law and of life, people will be more successful when they plan before acting. Although bestowing advantages upon those who plan is not unique to tax law, the tax benefits of planning before acting may be less widely understood than the benefits of planning in some other areas.[10] Because of this, tax laws should be more forgiving, at least in certain situations.

This Article focuses on post-transactional tax decisions and discusses the ways in which tax law limits such decisions, the underlying goals that might be served by existing limitations, and how the law could better address these underlying goals. Part I provides examples of doctrines and rules that curb post-transactional tax decisions, focusing in particular on the application of the actual transaction doctrine in certain situations. Part II discusses in more detail the underlying goals that may be served by restricting post-transactional tax decisions. Part III analyzes the extent to which limitations on post-transactional tax decisions serve the underlying goals discussed in Part II through the lens of the actual transaction doctrine. Part IV suggests reform that could better serve these goals, suggesting that, in some circumstances,

---

9. *See infra* Part III.

10. In some areas of law, the applicable rules may be consistent with the intuitive assumptions of unsophisticated persons. For example, subject to important exceptions, a failure to use a particular form will not generally prevent parties from forming a binding contract as long as their statements and actions objectively demonstrate their intent to be bound. *See, e.g.*, RESTATEMENT (SECOND) OF CONTRACTS § 22(2) (1981) ("A manifestation of mutual assent may be made even though neither offer nor acceptance can be identified and even though the moment of formation cannot be determined."); U.C.C. § 2-204(1)–(2) (2011) ("A contract for sale of goods may be made in any manner sufficient to show agreement, including conduct by both parties which recognizes the existence of such a contract. An agreement sufficient to constitute a contract for sale may be found even though the moment of its making is undetermined."). This lack of emphasis on formal requirements allows parties to create contracts when they may naturally assume they have done so. Thus, unsophisticated parties who do not seek legal advice before acting may not be significantly disadvantaged because the legal consequences follow from the parties' apparent intent, and the legal consequences do not depend on whether the parties complied with technical requirements. On the other hand, often in tax law, a minor change to a transactional form can have a significant impact on the tax outcome. *See infra* Part I.B. It is not intuitive that structuring a transaction in a slightly different manner dramatically affects tax outcomes. Thus, unsophisticated taxpayers may be unaware of the potential benefits of tax planning before carrying out a transaction, and, under current law, they may be significantly disadvantaged by their failure to engage in pre-transactional tax planning.

taxpayers should be given a second chance when they fail to obtain adequate tax advice before undertaking a transaction. Finally, Part V concludes that occasionally limiting post-transactional tax decisions may exacerbate the negative effects of pre-transactional tax decisions because these limitations bestow an even greater advantage upon taxpayers who plan before a transaction.

I. CURBING POST-TRANSACTIONAL TAX DECISIONS: HOW TAX LAW PREVENTS SECOND CHANCES

A variety of judicial doctrines, statutes, and regulations discourage post-transactional tax decisions.[11] One example is the actual transaction doctrine.[12] According to this doctrine, a taxpayer must report the tax consequences that follow from the actual transaction undertaken rather than the tax consequences that would have followed from some hypothetical, equivalent transaction that the taxpayer did not pursue.[13] Understanding the doctrine and its limitations requires knowledge of tax law's treatment of substance and form.

A. Background: Substance over Form or Form over Substance?

In many cases, the tax consequences of a transaction are determined based on the underlying substance of the transaction rather than its form.[14] For example, assume an individual, Ms. Jones, owns 100% of the outstanding

11. *See infra* note 12 and accompanying text.

12. Other examples exist, including: (1) the non-disavowal doctrine; (2) limitations on the retroactivity of tax elections; (3) rules curbing the duplication or shifting of an existing economic loss; and (4) limitations on a taxpayer's ability to unwind a transaction. *See, e.g.* Douglas A. Kahn and Jeffrey H. Kahn, *Prevention of Double Deductions of a Single Loss: Solutions in Search of a Problem*, 26 VA. TAX REV. 1 (2006) (discussing some of the rules that curb the duplication or shifting of an existing economic loss); *see also infra* notes 114–25 and accompanying text (discussing the limitations on the retroactivity of tax elections); *infra* notes 73–97 and accompanying text (further discussing the non-disavowal doctrine); *infra* notes 98–113 and accompanying text (discussing rescission and unwinding).

13. *See* Michael E. Baillif, *The Return Consistency Rule: A Proposal for Resolving the Substance-Form Debate*, 48 TAX LAW. 289, 310–11 (1995) (quoting Comm'r v. Nat'l Alfalfa Dehydrating & Milling Co., 417 U.S. 134, 149 (1974)) (discussing the actual transaction doctrine); *see also* Emanuel S. Burstein, *The Impact of Form, and Disavowing Form, on Characterization of Sales Transactions*, 66 TAXES 220, 224 (1988) (providing additional information on the actual transaction doctrine); Kenneth L. Harris, *Should There Be a "Form Consistency" Requirement?* Danielson *Revisited*, 78 TAXES 88, 106–08 (2000); Robert Thornton Smith, *Substance and Form: A Taxpayer's Right to Assert the Priority of Substance*, 44 TAX LAW. 137, 141–43 (1990).

14. *See* Smith, *supra* note 13, at 137 ("A fundamental principle of . . . tax law is that taxation should be based upon the substance, and not the form, of transactions."). A complete discussion of substance-over-form in tax law is beyond the scope of this Article. *See, e.g.*, Hariton, *Sorting Out*, *supra* note 5, at 235–36 (discussing the economic substance doctrine); Isenberg, *supra* note 5, at 863–84; Kwall & Maynard, *supra* note 5, at 11–15; Rosenberg, *supra* note 5, at 385–88; Steinberg, *supra* note 5, at 457–500.

equity of Jones Corporation, an entity treated as a corporation for U.S. tax purposes. Assume Ms. Jones transfers $10,000 cash to Jones Corporation in exchange for a newly issued instrument labeled "debt." The resulting tax consequences of this transaction will depend on whether the instrument is actually treated as debt or, alternatively, is treated as equity for U.S. tax purposes.[15] If the instrument is debt for U.S. tax purposes, Jones Corporation will be entitled to deduct interest expense,[16] but if the instrument is considered equity for U.S. tax purposes, Jones Corporation will not be entitled to any deduction for payments made on the instrument.[17] The instrument will be treated as debt rather than equity only if the parties intend for Ms. Jones to have a definite right to be repaid a fixed amount at a certain time, regardless of the income of the corporation.[18] To determine the parties' intent, courts will examine underlying substantive factors rather than merely relying on the label given to the instrument by the taxpayer.[19] Substantive factors include: whether Jones Corporation is thinly capitalized, the liquidity of Jones Corporation's assets, the stability of Jones Corporation's revenues, the terms of the instrument (such as the length of the term to maturity), the fact that the "debt" is held by Jones Corporation's sole shareholder, and whether payments on the instrument are made when due.[20]

When substance matters, the IRS will often prevail if it argues that a transaction should be characterized consistently with its substance.[21] In the example above, if Jones Corporation deducts interest payments because the instrument was labeled "debt" and the IRS challenges this treatment citing to substantive factors such as thin capitalization, a very long term to maturity, and a history of payments not being made when due, the IRS's challenge will

---

15. BORIS I. BITTKER & JAMES S. EUSTICE, FEDERAL TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 4.01 (2d ed. 1989).

16. *Id.* ¶ 4.01[2] ("Section 163(a) allows the payor corporation to deduct 'all interest paid or accrued within the taxable year on indebtedness,' but no comparable deduction is allowed for distributions to the corporation's shareholders.").

17. *Id.*

18. *See, e.g.*, Bauer v. Comm'r, 748 F.2d 1365, 1367–68 (9th Cir. 1984) ("The determination of whether an advance is debt or equity depends on the distinction between a creditor who seeks a definite obligation that is payable in any event, and a shareholder who seeks to make an investment and to share in the profits and risks of loss in the venture."); Tomlinson v. 1661 Corp., 377 F.2d 291, 299 (5th Cir. 1967) (considering the intention of the parties); John Lizak, Inc. v. Comm'r, 28 T.C.M. (CCH) 804, 807 (1969) (analyzing whether there was an intent to repay or if the transfer of assets was intended to be a contribution to the corporation); Schnitzer v. Comm'r, 13 T.C. 43, 60 (1949) (emphasizing that the intention of the parties is relevant to a determination of an instrument's form).

19. *See Bauer*, 748 F.2d at 1367–68 (describing the court's consideration of the "circumstances and conditions of the advance").

20. *Id.* at 1368.

21. *See, e.g.*, Baillif, *supra* note 13, at 289 ("[T]he Service is routinely granted the right to look beyond the form of a transaction or its label on a tax return . . . .").

likely be successful.[22] Because of this preference for substance over form, the U.S. tax system is, in some respects, substance-driven.

Although the underlying substance determines the tax consequences of many transactions, the form of a transaction also has significance.[23] A transaction with a given underlying substance can often be embodied in a variety of forms.[24] Further, the tax consequences of one form may differ from the tax consequences of others. The taxpayer's chosen form will govern the resulting tax consequences when multiple forms lead to different tax consequences and when the forms are equally true to the transaction's underlying substance.[25] Because the form selected is consistent with the transaction's substance, the IRS cannot challenge the selected form based on the substance-over-form doctrine.[26] Thus, within certain limits, the U.S. tax system is also dependent on form. Consequently, as others have observed, there are two important and contradictory guidelines in tax law: (1) substance, rather than form, determines tax outcomes, and (2) form, rather than substance, determines tax outcomes.[27]

The actual transaction doctrine applies when form controls.[28] In cases involving the actual transaction doctrine, the IRS is not attempting to impose the tax consequences that would have followed from a form different than the one actually used.[29] Rather, the actual transaction doctrine is implicated when the taxpayer attempts to claim tax results that would have followed from a form other than the one actually chosen.[30] In such a case, the IRS can invoke the actual transaction doctrine to defeat the taxpayer's claim.[31]

---

22. *See supra* notes 18–21 and accompanying text.

23. *See infra* Part I.B (providing examples of how varying the transactional form can affect tax consequences). Tax elections provide another illustration of the significance of form in tax law. *See infra* notes 114–25 and accompanying text.

24. *See infra* Part I.B.

25. *See, e.g.*, Steinberg, *supra* note 5, at 488 (noting that a taxpayer's "transactional form will be respected so long as the substance . . . is consistent with the form").

26. *Id.*

27. *Id.* at 457 ("[T]here are two fundamental principles in [corporate tax] . . . : 'Substance controls, form does not' and 'form controls, substance does not.'").

28. *See infra* Part I.B (discussing situations when the actual transaction doctrine applies); *see also* Baillif, *supra* note 13, at 311 ("[T]he actual transaction principle does not pertain to a controversy about form versus substance. Instead, the principle applies when both the form and substance of a transaction correspond, but when a taxpayer argues for tax treatment based on a different transaction which she might have undertaken but did not.").

29. *See infra* Part I.B.

30. *See infra* Part I.B.

31. *See* Baillif, *supra* note 13, at 310–11 (arguing that the actual transaction doctrine applies when the form and substance of a transaction align but a taxpayer seeks different treatment).

B. When Does the Actual Transaction Doctrine Apply?

The actual transaction doctrine prevents post-transactional tax decisions.[32] The doctrine applies in three situations: (1) the unexpected economic outcome situation; (2) the inadequate pre-transactional tax-planning situation; and (3) the overly aggressive pre-transactional tax-planning situation.[33]

1. The Unexpected Economic Outcome Situation: The Best Laid Tax Plans Often Go Awry

The unexpected economic outcome situation arises when a taxpayer opts for a transactional form that leads to favorable tax consequences given the expected economic outcome of a transaction. Unfortunately, the economic outcome turns out to be different than expected and the taxpayer realizes in retrospect that an alternative form would have led to more favorable tax consequences. As a result, the taxpayer attempts to claim those consequences that are more favorable. The actual transaction doctrine binds the taxpayer to the tax consequences that follow from the form originally chosen.[34]

---

32. The actual transaction doctrine, in some circumstances, could serve other goals in addition to preventing post-transactional tax decisions. One such goal is encouraging consistent reporting among the parties to a transaction. If one party reports tax results in a manner that is inconsistent with the form actually used, he or she may also report tax consequences in a manner that is inconsistent with the way other parties to the transaction report tax consequences should they report tax consequences in a manner consistent with the form actually used. Yet, in some cases, this inconsistency will not occur because all parties to the transaction will seek to report results consistent with the same alternative form of the transaction. A second concern that can justify the actual transaction doctrine, in some circumstances, is that one party to a transaction could be unjustly enriched at the expense of another party to the transaction if the parties established the terms of the transaction on the assumption that tax results would be reported based on the form actually used and results are, instead, reported based on an alternative form. Although this may be a concern in some circumstances, as others have suggested in the context of the non-disavowal doctrine, such unjust enrichment could perhaps best be addressed in a private civil action between the parties to the transaction. *See, e.g.*, Baillif, *supra* note 13, at 309–10. Furthermore, concerns regarding unjust enrichment are mitigated in situations in which all parties agree to report results consistently with an alternative transactional form because, in such situations, presumably no party would agree to the alternative reporting unless the party was adequately compensated for doing so. As discussed below, the proposed reforms would apply only in a situation in which all parties agree to report based on an alternative form. *See infra* Part IV.A. A third rationale for the actual transaction doctrine is avoiding inconsistent reporting by a taxpayer over time. In particular, without the doctrine, a taxpayer might report results based on the form actually used in early years and results based on the alternative form in later years. This rationale, however, would not apply if a taxpayer had never reported results based on the form actually used. Moreover, a separate taxpayer duty of consistency would apply in cases of inconsistent reporting, even absent the actual transaction doctrine. For further discussion of the duty of consistency, see for example Baillif, *supra* note 13, at 290–94 and Steve R. Johnson, *The Taxpayer's Duty of Consistency*, 46 TAX L. REV. 537 (1991).

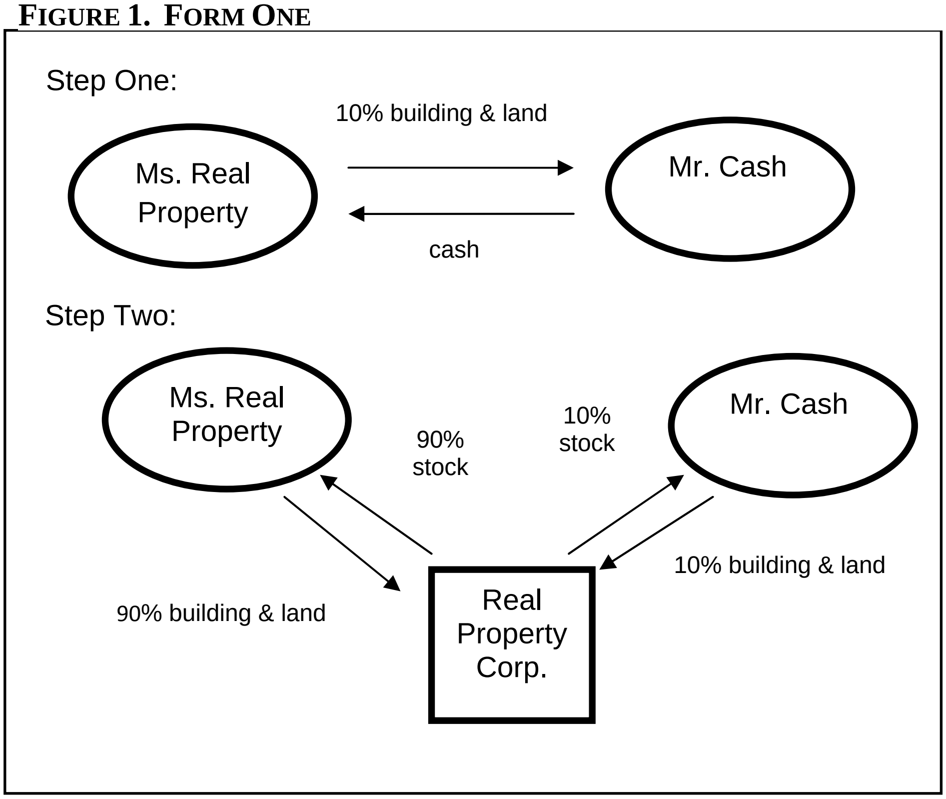
33. *See infra* Part I.B.1–3 (providing examples of all three instances).

34. For sources providing further description of the actual transaction doctrine, see *supra* note 13.

To illustrate the unexpected economic outcome situation, consider the following example. Two individuals, Ms. Real Property and Mr. Cash, want to form an entity (Real Property Corp.) to be treated as a corporation for tax purposes. Ms. Real Property will own a 90% interest in Real Property Corp. and Mr. Cash will own the remaining 10% interest. Real Property Corp. will own land and a building, assets that are currently owned by Ms. Real Property.[35] The parties consider two possible paths to reach their goals.

The first path (Form One) involves two steps. First, Mr. Cash will pay cash to Ms. Real Property in an amount equal to 10% of the value of the land and the building and, in exchange, Ms. Real Property will transfer to Mr. Cash a 10% interest in each asset. Second, both Ms. Real Property and Mr. Cash will contribute their interests in the assets to Real Property Corp. in exchange for stock of Real Property Corp.[36]

FIGURE 1. FORM ONE

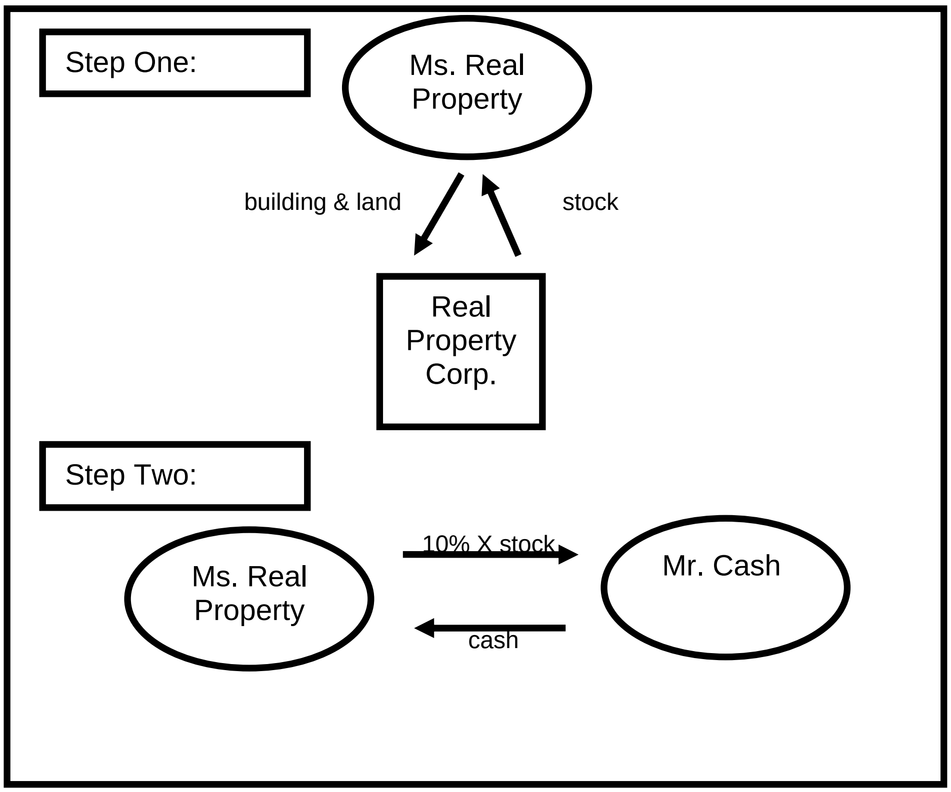


35. The following analysis assumes that Ms. Real Property holds the land, the building, and the Real Property Corp. stock as capital assets. It further assumes that Ms. Real Property held the land and the building for more than one year.

36. *See infra* FIGURE 1.

The second path (Form Two) also involves two steps. First, Ms. Real Property will contribute her entire interest in the land and in the building to Real Property Corp. in exchange for Real Property Corp. stock. Second, Mr. Cash will pay cash to Ms. Real Property in an amount equal to 10% of the value of the land and the building and, in exchange, Ms. Real Property will transfer 10% of Real Property Corp. stock to Mr. Cash.[37]

FIGURE 2. FORM TWO



Form One and Form Two have the same underlying substance; both forms result in Real Property Corp. owning the land and the building, with Ms. Real Property owning 90% of Real Property Corp. stock, Mr. Cash owning 10% of Real Property Corp stock, and Mr. Cash transferring cash to Ms. Real Property.[38] Moreover, neither form of the transaction is truer to the underlying substance than the other.[39] Both forms involve the same number of steps, so it

37. *See infra* FIGURE 2.
38. *See supra* FIGURES 1 and 2 and accompanying text.
39. *See supra* FIGURES 1 and 2 and accompanying text.

is not the case that one form is more convoluted than the other.[40] Also, although both forms involve transitory ownership, neither form involves more transitory ownership than the other. In particular, in Form One, Mr. Cash holds a 10% interest in the assets for a brief period of time before he transfers this interest to Real Property Corp., and, in Form Two, Ms. Real Property similarly holds 10% of the stock of Real Property Corp. for a brief period of time before transferring it to Mr. Cash.[41] Consequently, neither form is likely to be successfully challenged based on the substance-over-form doctrine or similar rules by the IRS.[42] Therefore, whichever form is selected by the taxpayers will control the resulting tax consequences.

To achieve the most favorable results, the parties will evaluate the expected tax consequences of both forms. Assume that the parties do not know the value of the land and the building. They agree that an appraisal will establish the value, and they will conduct that appraisal after they undertake the transaction. They assume that the assets both have built-in gains—in other words, they assume that the fair market value of each asset is greater than Ms. Real Property's tax basis in that asset. If the assets have built-in gains, Form One would lead to more favorable tax consequences than Form Two.[43] Therefore, the parties opt for Form One.

---

40. *See supra* FIGURES 1 and 2 and accompanying text.

41. *See supra* FIGURES 1 and 2 and accompanying text.

42. *See supra* note 26 and accompanying text. Under I.R.C. § 351(a), the results could be different in the case of Form Two if Mr. Cash were acquiring a greater than 20% interest in Real Property Corp., and if at the time Ms. Real Property contributed the assets to Real Property Corp., Ms. Real Property had a legal obligation to transfer more than 20% of the stock of Real Property Corp. to Mr. Cash. *See* I.R.C. § 351(a). If such a legal obligation existed, the IRS could possibly challenge Ms. Real Property's claim that the first step of the transaction qualified for non-recognition treatment under § 351(a) because, arguably, Ms. Real Property did not own 80% of the Corporation's stock immediately after she exchanged her property for the stock. *See, e.g.*, Intermountain Lumber v. Comm'r, 65 T.C. 1025, 1031 (1976) ("If the transferee, as part of the transaction by which the shares were acquired, has irrevocably foregone or relinquished at that time the legal right to determine whether to keep the shares, ownership in such shares is lacking for purposes of section 351.").

43. For example, assume Ms. Real Property's tax basis in the land is $50 but the fair market value of the land is $75, and Ms. Real Property's tax basis in the building is $50 but the fair market value of the building is $60. Based on these assumptions, the tax consequences of Form One would be as follows: As a result of Step One, Ms. Real Property recognizes $2.50 of tax gain from sale of the land (Ms. Real Property's basis in 10% of the land is $5 and Ms. Real Property sells 10% of the land for $7.50), and Ms. Real Property recognizes $1 of tax gain from sale of the building (Ms. Real Property's basis in 10% of the building is $5 and Ms. Real Property sells 10% of the building for $6). Thus, Ms. Real Property recognizes $3.50 total of tax gain, all of which is long-term capital gain based on the aforementioned assumption. *See supra* note 35. After completion of Step One, but prior to Step Two, Ms. Real Property continues to hold a 90% interest in the land with a basis of $45 and a 90% interest in the building with a basis of $45. Mr. Cash holds a newly acquired 10% interest in the land with a basis of $7.50 and a fair market value of $7.50, and Mr. Cash holds a newly acquired 10% interest in the building with a basis of $6 and a fair market value of $6. Next, as Step Two, the individuals contribute these assets to Real Property Corp. in exchange for stock. As a result of Step Two, neither Ms. Real Property nor Mr.

After the parties have undertaken the transaction using the steps in Form One, they receive the appraisal results and discover that even though the land has a built-in gain, the building has an equal, offsetting, built-in loss. Given this actual economic outcome, Form Two may have led to more favorable tax consequences than Form One.[44]

Cash recognize any tax gain or loss, because property is being "transferred to [Real Property Corp.] by [Ms. Real Property and Mr. Cash] solely in exchange for stock in [Real Property Corp.] and immediately after the exchange [Ms. Real Property and Mr. Cash] are in control . . . of [Real Property Corp.]" I.R.C. § 351(a). Ms. Real Property receives a 90% interest in Real Property Corp. stock with a basis of $90 (the basis of the land, $45, and the building, $45, that Ms. Real Property contributes) and a holding period of more than one year. *See id.* §§ 358(a)(1), 1223(1); assumptions mentioned *supra* note 35. Mr. Cash receives a 10% interest in Real Property Corp. stock with a basis of $13.50 (the basis of the land and the building that Mr. Cash contributes). I.R.C. § 358(a)(1). Real Property Corp. holds land with a basis of $52.50 (the basis of the land Ms. Real Property contributes ($45) plus the basis of the land Mr. Cash contributes ($7.50)), and Real Property Corp. holds a building with a basis of $51 (the basis of the building Ms. Real Property contributes ($45) plus the basis of the building Mr. Cash contributes ($6)). *Id.* § 362(a). By contrast, the tax consequences of Form Two would be as follows: As a result of Step One, Ms. Real Property does not recognize any tax gain or loss. *Id.* § 351(a). Ms. Real Property receives a 100% interest in Real Property Corp. stock with a basis of $100 (the basis of the land, $50, and the building, $50, that Ms. Real Property contributes) and a holding period of more than one year. *See* I.R.C. §§ 358(a)(1), 1223(1); assumptions mentioned *supra* note 35. Real Property Corp. holds land with a basis of $50 (Ms. Real Property's basis in the land) and a building with a basis of $50 (Ms. Real Property's basis in the building). I.R.C. § 362(a). The fair market value of Real Property Corp. stock is $135 (the fair market value of the land transferred by Ms. Real Property, $75, plus the fair market value of the building transferred by Ms. Real Property, $60). For simplicity, this calculation ignores the effects on the stock's fair market value of the corporation's pending tax liability. As a result of Step Two, Ms. Real Property recognizes $3.50 of tax gain from sale of 10% of the stock (Ms. Real Property's basis in 10% of the stock is $10 and Ms. Real Property sells 10% of the stock for $13.50). This tax gain is long-term capital gain because Ms. Real Property's holding period in the stock is more than one year and she holds the stock as a capital asset. *See supra* note 35. Following the sale, Ms. Real Property continues to hold 90% of the Real Property Corp. stock with a basis of $90, and Mr. Cash holds a newly acquired 10% interest in the Real Property Corp. stock with a fair market value basis of $13.50. The sale of Real Property Corp. stock has no effect on Real Property Corp.'s basis in the underlying assets (Real Property Corp. still has a $50 basis in each asset). The results of Form One and Form Two are identical in all respects but for Real Property Corp.'s basis in the assets. As a result of Form One, Real Property Corp. is left with a basis in the land of $52.50 and a basis in the building of $51. As a result of Form Two, Real Property Corp. is left with a basis in the land of $50 and a basis in the building of $50. Because Form One leads to tax consequences that are identical to those following from Form Two, except for the fact that Real Property Corp. has a higher tax basis in its assets, the tax consequences that follow from Form One are more favorable.

44. Assume, for example, Ms. Real Property's tax basis in the land is $50 and the fair market value of the land is $75, and Ms. Real Property's tax basis in the building is $50 and the fair market value of the building is $25. Based on these assumptions, the tax consequences of Form One would be as follows: As a result of Step One, Ms. Real Property recognizes $2.50 of tax gain from the sale of the land (Ms. Real Property's basis in 10% of the land is $5 and Ms. Real Property sells 10% of the land for $7.50), and Ms. Real Property recognizes $2.50 of tax loss from sale of the building (Ms. Real Property's basis in 10% of the building is $5 and Ms. Real Property sells 10% of the building for $2.50). Based on the aforementioned assumptions, the tax gain is long-term capital gain and the tax loss is long-term capital loss. *See supra* note 35. Thus

If the parties claimed the results of Form Two, arguing that they could have carried out the transaction in that manner, it is likely the IRS could successfully challenge the taxpayers and require that they report the less favorable results following from Form One, the form actually used.[45] As one court articulating the actual transaction doctrine stated, "[W]hile a taxpayer is free to organize his affairs as he chooses, nevertheless, once having done so, he

---

Ms. Real Property recognizes $0 of net tax gain. After completion of Step One, but prior to Step Two, Ms. Real Property continues to hold a 90% interest in the land with a basis of $45 and a 90% interest in the building with a basis of $45. Mr. Cash holds a newly acquired 10% interest in the land with a basis of $7.50 and a fair market value of $7.50, and Mr. Cash holds a newly acquired 10% interest in the building with a basis of $2.50 and a fair market value of $2.50. Next, as Step Two, the individuals contribute these assets to Real Property Corp. in exchange for stock. As a result of Step Two, neither Ms. Real Property nor Mr. Cash recognize any tax gain or loss. I.R.C. § 351(a). Ms. Real Property receives a 90% interest in Real Property Corp. stock with a basis of $90 (the basis of the land and the building that Ms. Real Property contributes) and a holding period of more than one year. *Id.* §§ 358(a)(1), 1223(1); assumptions mentioned *supra* note 35. Mr. Cash receives a 10% interest in Real Property Corp. stock with a basis of $10 (the basis of the land, $7.50, and the building, $2.50, that Mr. Cash contributes). I.R.C. § 358(a)(1). Real Property Corp. holds land with a basis of $52.50 (the basis of the land Ms. Real Property contributes ($45) plus the basis of the land Mr. Cash contributes ($7.50)), and Real Property Corp. holds a building with a basis of $47.50 (the basis of the building Ms. Real Property contributes ($45) plus the basis of the building Mr. Cash contributes ($2.50)). *Id.* § 362(a). These results are not affected by I.R.C. § 362(e)(2) because the assets that Real Property Corp. receives from Ms. Real Property do not have a net built-in loss. *Id.* § 362(e)(2). By contrast, the tax consequences of Form Two would be as follows: As a result of Step One, Ms. Real Property does not recognize any tax gain or loss. *Id.* § 351(a). Ms. Real Property receives a 100% interest in Real Property Corp. stock with a basis of $100 (the basis of the land and the building that Ms. Real Property contributes) and a holding period of more than one year. *Id.* §§ 358(a)(1), 1223(1); assumptions mentioned *supra* note 35. Real Property Corp. holds land with a basis of $50 (Ms. Real Property's basis in the land) and a building with a basis of $50 (Ms. Real Property's basis in the building). I.R.C. § 362(a). These results are not affected by § 362(e)(2) because the assets that Real Property Corp. receives from Ms. Real Property do not have a net built-in loss. *Id.* § 362(e)(2). The value of the Real Property Corp. stock is $100 (the fair market value of the land, $75, and the building, $25, that Ms. Real Property contributes). As a result of Step Two, Ms. Real Property recognizes $0 of tax gain from sale of 10% of the stock (Ms. Real Property's basis in 10% of the stock is $10 and Ms. Real Property sells 10% of the stock for $10). Following the sale, Ms. Real Property continues to hold 90% of the Real Property Corp. stock with a basis of $90, and Mr. Cash holds a newly acquired 10% interest in the Real Property Corp. stock with a fair market value basis of $10. The sale of Real Property Corp. stock has no effect on Real Property Corp.'s basis in the underlying assets (so Real Property Corp. still has a $50 basis in each asset). The results of Form One and Form Two are identical in all respects except for Real Property Corp.'s basis in the assets. As a result of Form One, Real Property Corp. is left with a basis in the land of $52.50 and a basis in the building of $47.50. As a result of Form Two, Real Property Corp. is left with a basis in the land of $50 and a basis in the building of $50. Consequently, under Form Two, Real Property Corp. has a basis in the land that is $2.50 lower and a basis in the building that is $2.50 higher than what resulted from Form One. Assuming the building is depreciable, and the land will not be sold for many more years, having a $2.50 higher basis in the building and a $2.50 lower basis in the land would lead to more favorable tax consequences, taking into account the time value of money. As a result, Form Two may lead to more favorable tax consequences than Form One.

45. *See supra* note 13 and accompanying text.

must accept the tax consequences of his choice, whether contemplated or not, . . . and may not enjoy the benefit of some other route he might have chosen to follow but did not."[46] In sum, the best-laid tax plans often go awry because a transaction structured with one economic outcome in mind may lead to suboptimal tax consequences when the economic outcome turns out to be different than expected.

2. The Inadequate Pre-Transactional Tax-Planning Situation: Never Put off Until Tomorrow Tax Planning You Could Do Today

In the inadequate pre-transactional tax planning situation, a taxpayer fails to engage in effective tax planning before undertaking a transaction, likely because the taxpayer receives poor tax advice or does not seek any advice. Consequently, only after embarking upon the transaction does the taxpayer discover that using an alternative transactional form would have been advisable. After making this discovery, the taxpayer argues that he or she is entitled to the tax consequences of that alternative form. The actual transaction doctrine prohibits this argument and enforces the tax consequences of the taxpayer's actual transaction.[47]

The inadequate pre-transactional tax planning situation is illustrated by the facts of *Glacier State Electrical Supply Co. v. Commissioner*.[48] To simplify the facts somewhat, in *Glacier State*, two individuals, "Exiting Shareholder" and "Remaining Shareholder," each owned 50% of the stock of Parent, an entity treated as a corporation for tax purposes.[49] In turn, Parent owned two-thirds of the stock of Subsidiary, another entity treated as a corporation for tax purposes.[50] The remaining one-third of Subsidiary's stock was owned by "Other Remaining Shareholder," a third individual.[51]

46. Comm'r v. Nat'l Alfalfa Dehydrating & Milling Co., 417 U.S. 134, 149 (1974) (citations and footnotes omitted); *see, e.g.*, Nestlé Holdings Inc. v. Comm'r, 152 F.3d 83, 87 (2d Cir. 1998) (applying the actual transaction doctrine in the unexpected economic outcome situation).

47. *See supra* note 13 and accompanying text.

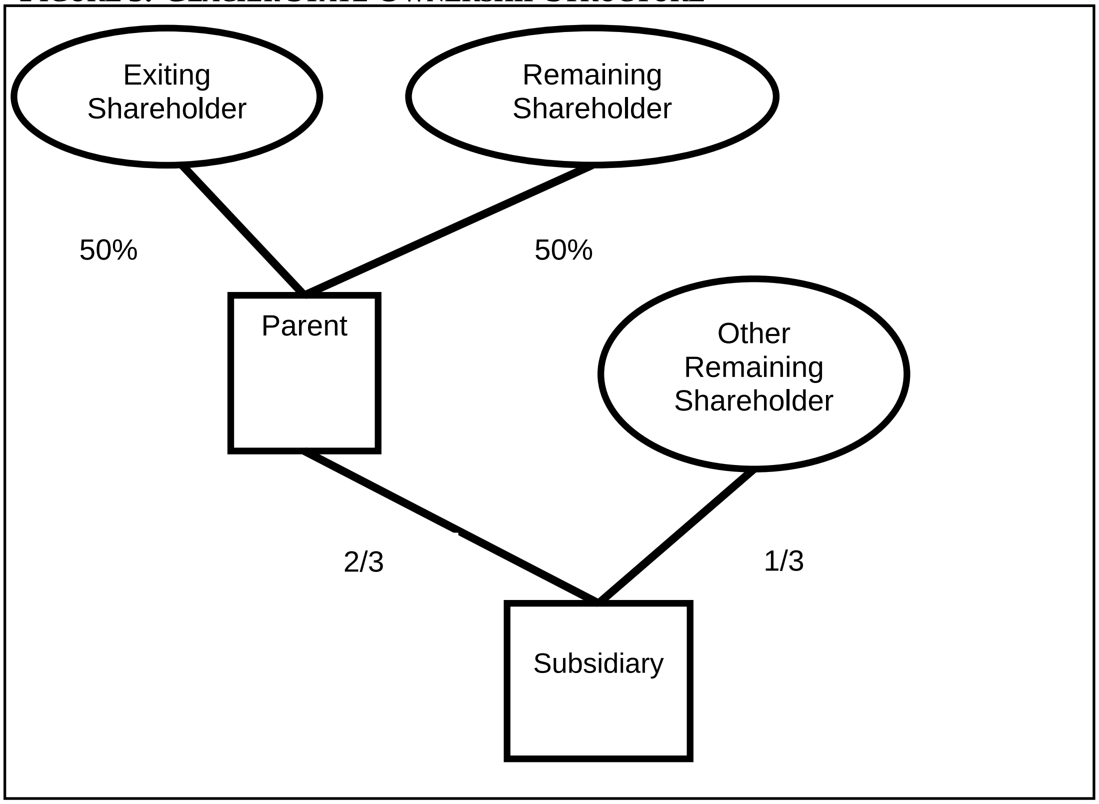
48. Glacier State Elec. Supply Co. v. Comm'r, 80 T.C. 1047, 1049–54 (1983).

49. *Id.* at 1049.

50. *Id.*

51. *Id.*

FIGURE 3. *GLACIER STATE* OWNERSHIP STRUCTURE



Upon Exiting Shareholder's death, Subsidiary redeemed one-half of the stock in Subsidiary held by Parent in exchange for a check and a note.[52] Parent, in turn, transferred the check and the note to Exiting Shareholder's estate to redeem the Parent stock held by Exiting Shareholder.[53] Under the tax law in effect at the time, the transaction undertaken by the parties led to less favorable tax consequences than an alternative, equivalent transaction.[54] In particular, the parties would have achieved more favorable tax consequences if Parent had first distributed half of its Subsidiary stock to Exiting Shareholder's estate in liquidation of Exiting Shareholder's interest in Parent and then subsequently Subsidiary had redeemed the Subsidiary stock held by Exiting Shareholder's estate.[55]

Presumably, the parties did not undertake the transaction in this alternative way because they failed to seek tax advice ahead of time or because they received faulty tax advice. After the transaction was completed, the taxpayers claimed the tax consequences that would have resulted from the alternative transaction.[56] The court rejected the taxpayers' argument, relying on the actual transaction doctrine.[57] The court stated, "in essence [the taxpayers are] merely arguing that since the transaction would have been nontaxable if cast in another form, we should grant similar treatment to the form [they] utilized. This we cannot do."[58] Thus, as a result of the actual transaction doctrine,

52. *Id.* at 1050–51.

53. *Id.*

54. Both the stock in Parent that Exiting Shareholder held, and the stock in Subsidiary that Parent held, had built-in gains. As a result, the form of the transaction utilized by the parties resulted in recognition of two levels of gain for tax purposes. First, Parent recognized a tax gain upon receipt of a check and a note with a value that exceeded Parent's basis in the Subsidiary stock, and, second, Exiting Shareholder recognized a tax gain upon receipt of a check and a note with a value that exceeded Exiting Shareholder's basis in the Parent stock. By contrast, if the parties had utilized the alternate form of the transaction, only one level of tax gain would have been recognized. The transaction occurred before the repeal of the "General Utilities" doctrine. Therefore, under the law in effect at the time, Parent would not have recognized any gain as a result of distributing the Subsidiary stock to Exiting Shareholder, and Exiting Shareholder would have obtained a fair market value basis in the Subsidiary stock. Exiting Shareholder would have recognized one level of tax gain on the Parent stock when Exiting Shareholder received Subsidiary stock with a fair market value that exceeded Exiting Shareholder's basis in Parent stock. However, because Exiting Shareholder obtained a fair market value basis in Subsidiary stock, Exiting Shareholder would not recognize any further tax gain upon receiving a check and a note in redemption of the Subsidiary stock. Structured in this manner, only the tax gain built into the Parent stock would be recognized, as opposed to both the tax gain built into the Parent stock and the tax gain built into the Subsidiary stock.

55. *See supra* note 54

56. *Glacier State*, 80 T.C. at 1054.

57. *Id.* at 1057–58.

58. *Id.* at 1058. For other cases that apply the actual transaction doctrine in the inadequate pre-transactional tax planning situation, see Abrams v. United States, 797 F.2d 100, 105 (2d Cir. 1986); Television Indust., Inc. v. Comm'r, 284 F.2d 322, 325 (2d Cir. 1960); Lane v. United

taxpayers are well advised to tax plan today because, if the transaction has already commenced, tomorrow may be too late.

3. The Overly Aggressive Pre-Transactional Tax-Planning Situation: Look for More Certain Tax Strategies Before Leaping into an Aggressive Strategy

In the overly aggressive pre-transactional tax-planning situation, a taxpayer could carry out a transaction using any one of at least three forms. The first form (Form One) and the second form (Form Two) are both fairly safe choices; both are unlikely to be successfully challenged by the IRS.[59] Between the first two forms, Form One results in tax consequences that are more favorable than those following from Form Two.[60] A third form (Form Three) leads to the best possible tax consequences if the form of the transaction is unchallenged by the IRS based on substance-over-form principles.[61] However, Form Three is also the least likely form to survive an IRS challenge.[62] In hopes of achieving the best possible tax consequences, the taxpayer selects Form Three. Subsequently, the IRS successfully challenges the claimed tax consequences and asserts that the resulting tax consequences should be those that would have followed from Form Two under a substance-over-form analysis.[63] The taxpayer contends that he or she is entitled to the tax consequences that would have followed from Form One because the taxpayer could have successfully used that form. The actual transaction doctrine bars the taxpayer from claiming Form One's tax consequences.[64]

For an example of the overly aggressive pre-transactional tax planning situation, assume two individuals, Mr. Auto and Ms. Computer, plan to form a new limited liability company (LLC). Currently, Mr. Auto owns ten shares of stock of one publicly traded company (Auto Corp.), and Ms. Computer owns ten shares of stock of another publicly traded company (Computer Corp.). Each share of Auto Corp. stock is worth $30 and has a tax basis of $40 in Mr. Auto's hands. Each share of Computer Corp. stock is worth $30 and has a tax basis of $20 in Ms. Computer's hands. After the parties form the LLC, it will own the shares of Auto Corp. and Computer Corp. Both Mr. Auto and Ms. Computer would like to own a 50% interest in the new LLC. The parties consider three possible routes to this desired result.

The first route (Form One) involves the following steps: first, Mr. Auto buys five shares of Computer Corp. stock from Ms. Computer in exchange for five

---

States, 535 F. Supp. 397, 401 (S.D. Miss. 1981); Dyess v. Comm'r, 65 T.C.M. (CCH) 2717, 2725 (1993); and Battaglia v. Comm'r, 42 T.C.M. (CCH) 817, 822–23 (1981).

59. *See infra* FIGURES 4-6 and accompanying text.

60. *See infra* FIGURES 4–6 and accompanying text.

61. *See infra* FIGURES 4-6 and accompanying text.

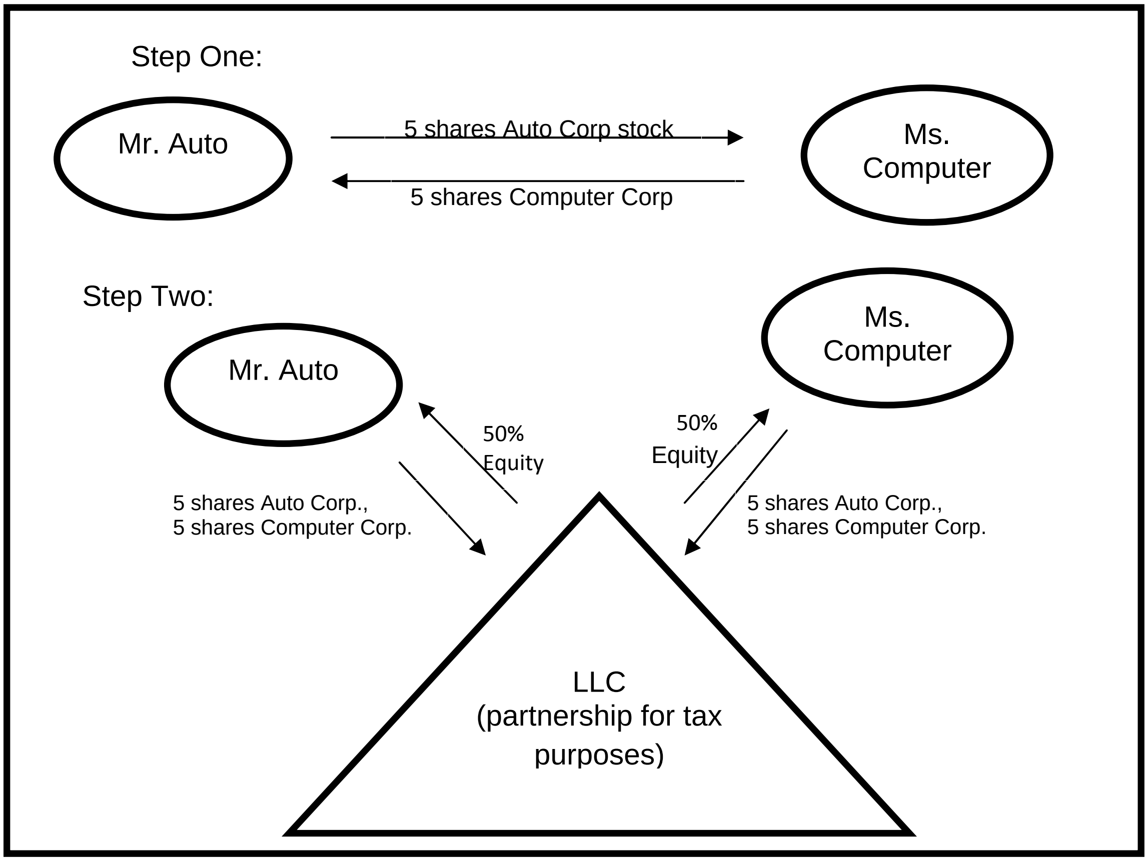
62. *See infra* FIGURES 4-6 and accompanying text.

63. *See infra* FIGURES 4-6 and accompanying text.

64. *See infra* FIGURES 4-6 and accompanying text.

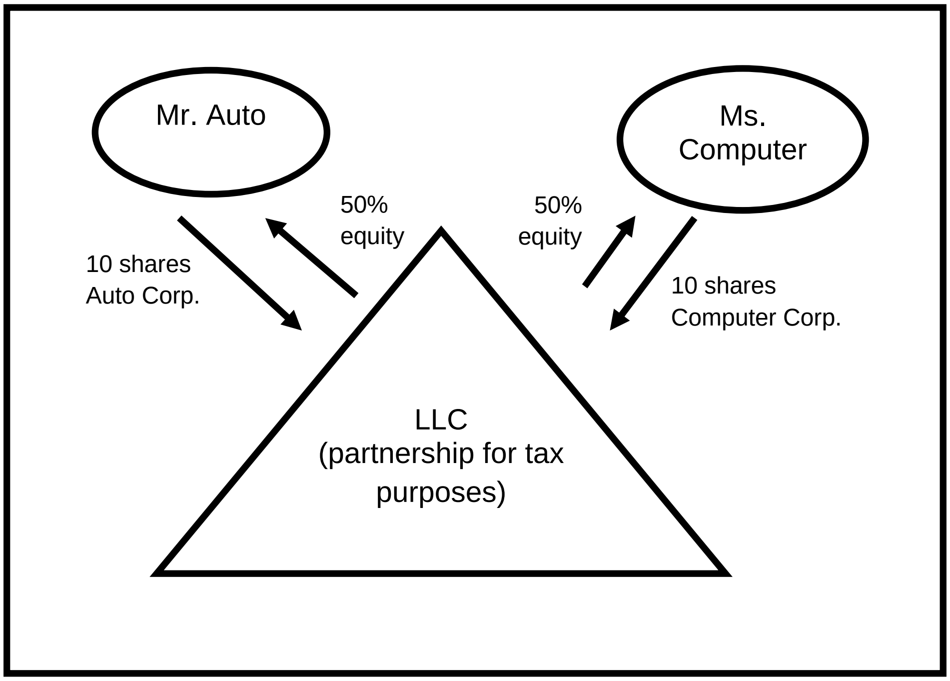
shares of Auto Corp. stock, and second, both Mr. Auto and Ms. Computer contribute their Auto Corp. and Computer Corp. shares to the LLC in exchange for 50% of the equity of the LLC.

FIGURE 4. FORM ONE



The second route (Form Two) only involves one step. Both Mr. Auto and Ms. Computer contribute the shares they hold to the LLC in exchange for 50% of the equity of the LLC.

FIGURE 5. FORM TWO



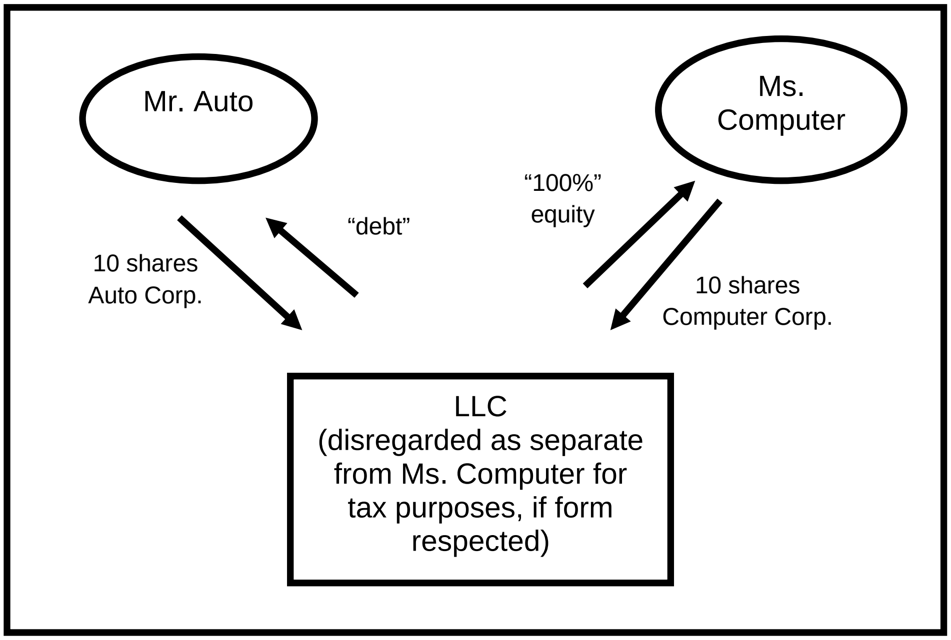
The third route (Form Three) involves the following exchanges: first, Ms. Computer contributes ten shares of Computer Corp. stock to the LLC in exchange for 100% of the equity of the LLC, and second, Mr. Auto sells ten shares of Auto Corp. stock to the LLC in exchange for an instrument issued by the LLC, labeled "debt." The "debt" has many equity-like features.[65] For instance, payments on the "debt" will partly depend on whether the LLC is profitable.[66]

---

65. For a discussion of features that make an instrument equity-like, see *supra* notes 15–20 and accompanying text.

66. For discussion of the distinction between debt and equity for tax purposes, see *supra* notes 15–20 and accompanying text.

FIGURE 6. FORM THREE



In this situation, if the taxpayers selected either Form One or Form Two and reported the tax consequences that followed from the form selected, the IRS would not likely challenge successfully the claimed tax consequences. It is possible that the IRS would challenge Form One because it involves an unnecessary step, and it would claim that the tax consequences that would have followed from Form Two are more appropriate.[67] However, the taxpayers could likely counter this argument by relying on the purpose of relevant tax rules.[68] Thus, Form One would likely be respected and lead to more favorable

---

67. *See supra* FIGURES 4–5.

68. In particular, the taxpayers could point to the purpose of I.R.C. § 721(b). Section 721(b) sets forth an exception to a general rule in § 721(a). I.R.C. § 721(b) (2006). Under the general rule in § 721(a), a taxpayer will not recognize tax gain or loss when he or she contributes property to a partnership in exchange for an equity interest in the partnership. *Id.* § 721(a). Under the exception, a partner will recognize gain—but not loss—upon contributing property to a partnership in exchange for an equity interest in the partnership if the partnership is an "investment company." *Id.* § 721(b). A partnership will be an "investment company" if (1) the transfer results in a "diversification" of the contributing partner's interests and (2) more than 80% of the value of the partnership's assets are "held for investment and are readily marketable stocks or securities." Treas. Reg. § 1.351-1(c)(1) (2011). Thus, § 721(b) is designed to prevent taxpayers from diversifying their stock holdings without recognizing a taxable gain. In the transactions shown in Figures 4 and 5, Mr. Auto and Ms. Computer diversify their stockholdings. Before the transaction, each owns ten shares of one corporation. After the transaction, they each

tax consequences than Form Two.[69] Form Three is the most likely to be challenged successfully by the IRS.[70] However, if none of the forms were challenged and tax consequences of each transaction were reported based on the form of the transaction, Form Three would lead to the most favorable tax results.[71]

---

own a 50% interest in a partnership that itself owns 10 shares of two corporations. Thus, afterwards, they each indirectly have an economic interest in five shares of two corporations. Mr. Auto and Ms. Computer could have achieved the same diversification if Ms. Computer had simply purchased five shares of Auto Corp. stock from Mr. Auto in exchange for five shares of Computer Corp. stock. If they had engaged in this direct sale, Ms. Computer and Mr. Auto would have recognized the same amount of gain and loss that they recognize if they engage in the transaction using Form One. Therefore, using Form One does not subvert the purpose of § 721(b) given that Form One results in the same amount of gain and loss recognition that would have occurred if the parties had directly diversified their stockholdings.

69. Under Form One, Step One, Mr. Auto recognizes $50 of tax loss upon a sale of five shares of Auto Corp. stock (with a basis of $40 per share or a total basis of $200) in exchange for five shares of Computer Corp. stock (with a fair market value of $30 per share or a total fair market value of $150). As a result of Step One, Ms. Computer recognizes $50 of tax gain upon sale of five shares of Computer Corp. stock (with a basis of $20 per share or a total basis of $100) in exchange for five shares of Auto Corp. stock (with a fair market value of $30 per share or a total fair market value of $150). Because of Step Two, neither Mr. Auto nor Ms. Computer recognize any further tax gain or loss. I.R.C. § 721(a). Section 721(b) does not affect this result because Step Two does not result in diversification as Mr. Auto and Ms. Computer contribute identical assets to the LLC. Treas. Reg. § 1.351-1(c)(1), 1.351-1(c)(5). In summary, as a result of Form One, Mr. Auto recognizes $50 of tax loss, and Ms. Computer recognizes $50 of tax gain. By contrast, as a result of Form Two, Mr. Auto recognizes no tax loss, and Ms. Computer recognizes $100 of tax gain. I.R.C. § 721(a), 721(b). Under Form Two, Mr. Auto recognizes no tax loss because § 721(a) applies, and this result is not affected by § 721(b) because § 721(b) applies to tax gains but not tax losses. *Id.* § 721(b). Ms. Computer recognizes all tax gains realized on the transaction per § 721(b). The amount of Ms. Computer's realized (and, thus, recognized) tax gain is $100 because Ms. Computer transfers Computer Corp. stock with a total basis of $200 ($20 per share times ten shares) to the LLC in exchange for an equity interest in the LLC that has a fair market value of $300 or, assuming the LLC owes no liabilities, 50% of the fair market value of the LLC's assets (the fair market value of Auto Corp. stock, $300, plus the fair market value of Computer Corp. stock, $300).

70. The IRS could argue that the "debt" is really equity for tax purposes, given its equity-like features. *See supra* notes 18–20 and accompanying text (discussing whether an instrument is debt or equity for tax purposes). If the "debt" in Form Three is treated as equity for tax purposes, Form Three will be treated as identical to Form Two for tax purposes.

71. If the "debt" is treated as debt for tax purposes, the results that follow from Form Three would be as follows: Mr. Auto recognizes all realized loss upon exchanging the Auto Corp. stock for the debt instrument. Thus, Mr. Auto recognizes $100 of tax loss. Ms. Computer recognizes no tax gain because her contribution of Computer Corp. stock to the LLC is ignored because the LLC is disregarded as separate from Ms. Computer for tax purposes. Because Ms. Computer owns 100% of the equity in the LLC, it will be disregarded as separate from Ms. Computer for tax purposes, as long as Ms. Computer does not file an election to treat LLC as a corporation. Treas. Reg. § 301.7701-3(b)(1)(ii). Finally, Ms. Computer will not recognize any income or gain when Mr. Auto transfers Auto Corp. stock to the LLC because the LLC exchanges debt for the Auto Corp. stock. Consequently, the Auto Corp. stock is the proceeds of borrowing by the LLC.

Assume the parties opt for Form Three. Subsequently, the IRS challenges the parties' claimed tax consequences and imposes the tax consequences of Form Two because the "debt" received by Mr. Auto is substantively equity in the LLC. In response, the parties may argue that they should be entitled to the tax consequences that would have followed from Form One because they could have carried out their transaction using Form One. However, although it is true that the taxpayers could have undertaken the transaction using Form One, they did not do so. Further, because of the actual transaction doctrine, a court is unlikely to permit the taxpayers to claim retroactively the results of Form One in response to an audit.[72]

Consequently, if the taxpayers had engaged in less aggressive tax planning by using Form One, they would have achieved more favorable tax results than what ultimately followed the IRS's successful challenge to Form Three. Thus, taxpayers would be well advised to look for more certain tax strategies before leaping into an aggressive strategy.

C. What the Actual Transaction Doctrine is Not

To appreciate fully the limits of the actual transaction doctrine, it is useful to contrast it with two related yet different concepts: (1) the non-disavowal doctrine and (2) the limits on a taxpayer's ability to unwind a transaction for tax purposes. As discussion of these concepts will show, the actual transaction doctrine is not what stands in a taxpayer's way in every instance in which the taxpayer attempts to claim the tax consequences of a transaction other than the transaction he or she pursued.

1. The Non-Disavowal Doctrine

As discussed above, the tax consequences of a transaction are determined in numerous cases based on the underlying substance of the transaction, rather than merely its form.[73] In such cases, the IRS will often succeed in arguing that a transaction should be characterized consistently with its substance.[74] By contrast, form will often prevail over true substance when the taxpayer urges treatment in accordance with substance.[75] In other words, a taxpayer will face

---

72. *See*, *e.g.*, Glacier State Elec. Supply Co. v. Comm'r, 80 T.C. 1047, 1058 (1983) ("This Court also views with disfavor attempts by taxpayers to restructure transactions after they are challenged."); *see also* Estate of Durkin v. Comm'r, 99 T.C. 561, 575 (1992) (applying the actual transaction doctrine in the overly aggressive pre-transactional tax-planning situation).

73. *See supra* notes 14–22 and accompanying text.

74. *See supra* notes 14–22 and accompanying text.

75. For additional discussion, see BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 4.3.6 (2d ed. 1989). *See also* Baillif, *supra* note 13, at 289 ("Although the Service is routinely granted the right to look beyond the form of a transaction or its label on a tax return, a taxpayer's right to assert the same privilege is, at best, uncertain"). *See generally* Michael Baillif, *When (and Where) Does the Danielson Rule Limit Taxpayers Arguing "Substance over Form"?*, 82 J. TAX'N 362 (1995); William S. Blatt, *Lost on a One-Way Street: The Taxpayer's Ability to Disavow Form*, 70 OR. L. REV. 381 (1991);

significant opposition when arguing that a transaction should not be characterized in accordance with the form that the taxpayer adopted but rather by its true substance.[76] This notion is embedded in what is known as the non-disavowal doctrine, aptly named because it limits a taxpayer's ability to disavow the form that he or she chose.[77]

Both the non-disavowal doctrine and the actual transaction doctrine limit post-transactional tax decisions. Both doctrines accomplish this by preventing a taxpayer from claiming tax consequences that would have followed from a transactional form other than one selected.

Although both doctrines limit post-transactional tax decisions, they apply in slightly different situations. In particular, when the actual transaction doctrine applies, neither the taxpayer nor the IRS is able to argue for the tax consequences that would have followed from the non-selected form.[78] By contrast, when the non-disavowal doctrine applies, the taxpayer would not be able to argue for the tax consequences that would have followed from the alternative form, but the IRS would be permitted to do so based on substance-over-form principles.[79] Thus, in the examples described in Part I.B., the IRS could rely on the actual transaction doctrine to counter the taxpayer's attempt to effectuate a post-transactional tax decision.[80]

In each of these examples, the alternative form later claimed by the taxpayer was no more true to the transaction's underlying substance than the form actually used by the taxpayer.[81] Consequently, the IRS would not be able to impose the tax consequences that would have followed from the alternative form once the taxpayers selected the form actually used.[82] Because of this, the actual transaction doctrine, rather than the non-disavowal doctrine, applies to

---

Burstein, *supra* note 13; J. Bruce Donaldson, *When Substance-Over-Form Argument is Available to the Taxpayer*, 48 MARQ. L. REV. 41 (1964-1965); Harris, *supra* note 13; Christian A. Johnson, *The* Danielson *Rule: An Anodyne for the Pain of Reasoning*, 89 COLUM. L. REV. 1320 (1989); Smith, *supra* note 13.

76. A taxpayer's claim will not always fail. Moreover, when the taxpayer does win, facts often exist that could convince the court that the taxpayer's reason for choosing a form that was inconsistent with the transaction's substance was not to create opportunities for making post-transactional tax decisions. When a taxpayer seeks to convince the court of this, one factor that often assists the taxpayer is the existence of a non-tax explanation (or, at least, a non-U.S. federal income tax explanation—in other words, a state tax or foreign tax explanation may suffice) for why the chosen form of the transaction varied from its substance. *See* Grace Soyon Lee, *What's In a Name?: The Role of* Danielson *in the Taxation of Credit Card Securitizations*, 62 BAYLOR L. REV. 110, 112 (2010) ("[W]hen the Code discusses 'form,' it means form as used for tax purposes and not form as used in other areas, such as accounting.").

77. A complete discussion of the doctrine is beyond the scope of this Article. For additional discussion on the non-disavowal doctrine, see *supra* note 75.

78. *See supra* notes 28–31 and accompanying text.

79. *See infra* notes 95–97 and accompanying text.

80. *See supra* Part I.B.

81. *See supra* Part I.B.

82. *See supra* notes 23–31 and accompanying text.

prevent the taxpayers from claiming the tax consequences that would have followed from the alternative form once the taxpayers have selected the form actually used.

Maletis v. United States provides a useful example of the role of the non-disavowal doctrine.[83] In *Maletis*, the taxpayer established an entity to operate a wine manufacturing business.[84] In form, the taxpayer and his two sons owned the entity because paperwork had been filed with the IRS and state authorities indicating that the entity was owned by the three individuals and that all three had made contributions to the entity.[85] In substance, arguably only the taxpayer owned the entity.[86] His sons had not made their claimed contributions to the entity and, apparently, had no real involvement in the business.[87]

In the years when the business was profitable, the taxpayer filed tax returns in accordance with the form of the arrangement (in other words, the tax returns were consistent with the entity being a partnership owned by three individuals).[88] Thus, in years when the business generated taxable income, that income was reported in part by the taxpayer and in part by his sons.[89] This reporting led to less total tax liability than what would have occurred if all taxable income had been reported by the taxpayer, presumably because the sons were subject to lower effective tax rates than the taxpayer.[90]

In a later year, when the business generated a loss, however, the taxpayer claimed that he substantively owned the business in its entirety and there was no partnership.[91] Thus, the taxpayer asserted the right to deduct the entire tax loss, leading to lower tax liability than what would have resulted if the tax loss were shared between the taxpayer and his sons.[92] The IRS invoked the non-disavowal doctrine to challenge this treatment and asserted that the taxpayer was bound by the form he previously selected—that of a partnership.[93] The court held in favor of the IRS.[94]

The non-disavowal doctrine—rather than the actual transaction doctrine—applies in *Maletis* because establishing the business as a partnership, the form used by the taxpayer, was less true to the underlying substance of the transaction than an alternative form, namely, establishing the business as

83. Maletis v. United States, 200 F.2d 97 (9th Cir. 1952).
84. *Id.* at 98.
85. *Id.*
86. *Id.* at 97.
87. *Id.*
88. *Id.* 97–98.
89. *Id.* at 98.
90. *Id.*
91. *Id.* at 97.
92. *Id.*
93. *Id.* at 97–98.
94. *Id.*

wholly-owned by the taxpayer.[95] Consequently, even after the taxpayer selected the form of partnership, the IRS would be able to impose the tax consequences that would have followed from the alternative, more substance-based form of the wholly owned business.[96] Therefore, the non-disavowal doctrine applies to prevent the taxpayer from claiming the tax consequences that would have followed from the wholly owned business form once the taxpayer selected the partnership form.[97]

2. Limits on a Taxpayer's Ability to Unwind a Transaction for Tax Purposes

Occasionally, persons may decide to reverse the non-tax effects of a transaction. For example, a seller might sell property to a buyer for $1000, and the parties might subsequently decide to rescind the transaction. In this case, the buyer will return the property to the seller, and the seller will return $1000 to the buyer. An individual's motive for reversing a transaction may be non-tax-related. For example, a seller and buyer may realize that a sale was undesirable for business reasons, and consequently decide to rescind the sale. In other cases, however, the decision to reverse a transaction may be tax-motivated. For example, because a seller and buyer learn after a sale that the buyer's ownership of the property would produce undesirable tax effects, the parties may agree to undo the sale in an attempt to avoid these effects.

When parties reverse the non-tax effects of a transaction, they may claim that the original transaction and its reversal should be disregarded for tax purposes.[98] For example, the seller and buyer, under the facts assumed above, might assert, for tax purposes, that they are entitled to ignore the sale of the property and its rescission. If the transactions are ignored, the seller would not recognize any tax gain or loss on the sale, and none of the tax attributes of the property, such as its basis or holding period, would be affected by the transactions.[99] The seller would be treated as if he or she had continued to hold the property for an uninterrupted period of time.[100] In some cases, the IRS might take a contrary view of the transactions. In particular, the IRS may argue that both the original sale of the property from the seller to the buyer and the return of the property should be treated as events that trigger tax consequences.[101] Then, if the property had a built-in gain before the seller's sale, the seller would recognize a tax gain upon sale of the property to the buyer.[102]

95. *See supra* notes 78–79 and accompanying text.
96. *See supra* notes 78–79 and accompanying text.
97. *See supra* notes 78–79 and accompanying text.
98. David Hasen, *Unwinding Unwinding*, 57 EMORY L.J. 872, 877 (2008).
99. *Id.* at 873, 940–41.
100. *Id.* at 873.
101. *Id.*
102. *Id.* at 940–41.

A number of factors will influence a court when it decides whether to allow taxpayers to disregard a transaction and its reversal.[103] Some courts hesitate to allow a taxpayer to claim such treatment when the decision to reverse the transaction is tax-motivated.[104] This hesitancy is consistent with the aversion to post-transactional tax decisions.

The actual transaction doctrine is related to limitations on a taxpayer's ability to disregard a transaction and its reversal for tax purposes in that both features of tax law prevent post-transaction tax decisions.[105] Furthermore, limitations on a taxpayer's ability to disregard a transaction and its reversal can thwart the taxpayer's attempts to circumvent the actual transaction doctrine.[106] However, the concepts also differ in important respects. Each of these observations is discussed in more detail below.

Limitations on a taxpayer's ability to disregard a transaction and its reversal for tax reasons can frustrate taxpayers' attempts to make post-transactional tax decisions. In the unexpected economic outcome example described above, the taxpayers engaged in a transaction using the steps of Form One (Figure 1) and later discovered that they would have achieved more favorable tax consequences had they followed the steps of Form Two (Figure 2).[107] They could attempt to obtain the more favorable tax consequences following from Form Two by reversing the steps of Form One and, subsequently, carrying out the steps of Form Two. In particular, the taxpayers could reverse the steps of Form One as follows: first, Real Property Corp. distributes 90% of the building and the land to Ms. Real Property and 10% of the building and the land to Mr. Cash in cancellation of the Real Property Corp. stock. Second, Mr. Cash returns 10% of the building and the land to Ms. Real Property in exchange for a return of the amount paid. This reversal of Form One is shown in Figure 7. After reversing the steps of Form One, the taxpayers would undertake the steps of Form Two (shown in Figure 2 above).

---

103. A complete discussion of unwinding transactions is beyond the scope of this Article. For further discussion of rescission or unwinding, see generally Sheldon I. Banoff, *Unwinding or Rescinding a Transaction: Good Tax Planning or Tax Fraud?*, 62 TAXES 942 (1984) and Hasen, *supra* note 98. For further discussion of rescission in the context of post-transactional tax decisions, see Banoff, *supra*, at 942–47, 981–83, 986–87; Hasen, *supra* note 98, at 888–89, 935; and David H. Schnabel, *Revisionist History: Retroactive Federal Tax Planning*, 60 TAX LAW. 685 (2007).

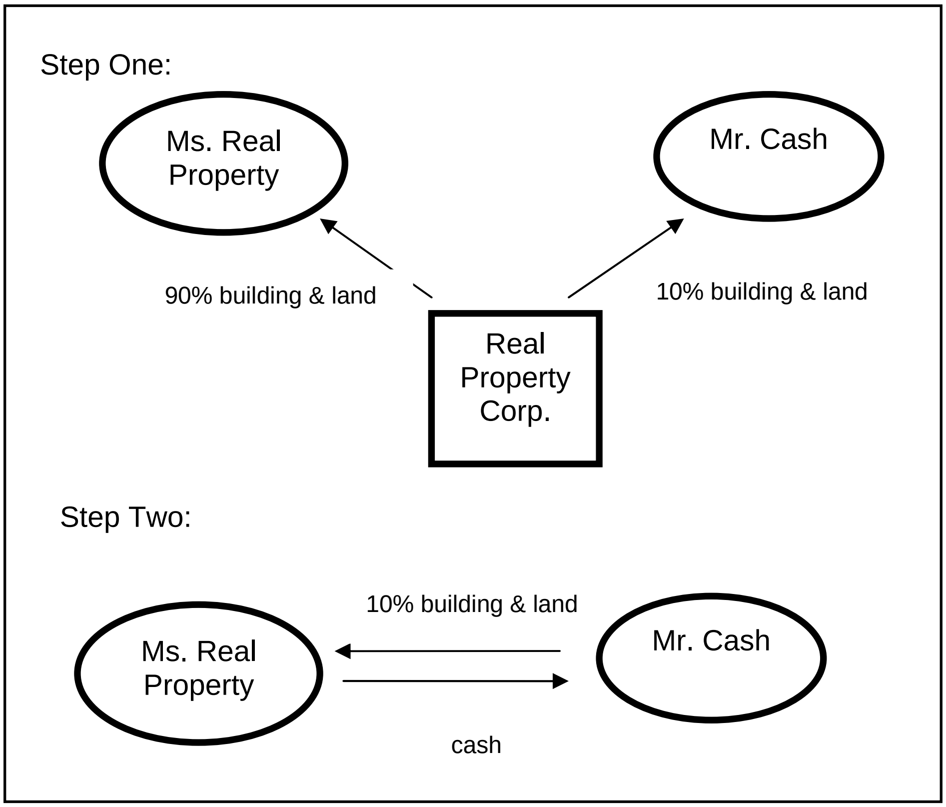
104. *See, e.g.*, Banoff, *supra* note 103, at 945, 947, 982–83, 986–87.

105. *See supra* Part I.B (discussing the actual transaction doctrine).

106. *See supra* Part I.B (discussing the actual transaction doctrine).

107. *See supra* Part I.B.1.

FIGURE 7. REVERSING FORM ONE



However, the strategy described above is effective only if the taxpayers can disregard, for tax purposes, the steps of Form One (Figure 1) and the reversal of those steps (Figure 7). If the taxpayers cannot disregard these steps, they will not succeed in avoiding undesirable tax consequences.[108] As described

108. If the original steps of Form One are not disregarded, they will still cause the tax consequences previously described. *See supra* note 44. If the steps taken to reverse Form One are not disregarded, Step One will be treated as a liquidation of Real Property Corp. *See supra* FIGURE 7. Because of the liquidation, Real Property Corp. will recognize gain with respect to the land in an amount equal to $22.50 ($75.00 minus $52.50). I.R.C. § 336(a) (2006). Real Property Corp. will recognize loss on the 10% of the building that is distributed to Mr. Cash (or $2.25 tax loss which equals 10% multiplied by (47.50 minus 25)). *Id.* However, Real Property Corp. will not recognize loss on the 90% of the building that is distributed to Ms. Real Property. *Id.* § 336(d)(1)(A)(ii). Ms. Real Property recognizes no gain or loss as a result of this liquidation because Ms. Real Property's tax basis in the Real Property Corp. stock equals the fair market value of property that Ms. Real Property receives. Under the same rationale, the same result is true for Mr. Cash. Finally, Ms. Real Property and Mr. Cash will each take a basis in the assets they receive that equals the assets' fair market value. *Id.* § 334(a). In summary, if the original steps of Form One and the reversal of those steps are not disregarded for tax purposes, the transactions will result in less favorable tax consequences than the consequences that would have

above, courts are reluctant to disregard a transaction and its reversal when the reversal is tax-motivated.[109] This reluctance restrains taxpayers' ability to make post-transactional tax decisions.

Moreover, this reluctance thwarts attempts by taxpayers to bypass the actual transaction doctrine. If the taxpayers in the example above could reverse the steps of Form One and be treated, for tax purposes, as if they had never undertaken those steps, the taxpayers would be able to achieve the tax consequences of Form Two. They could do so notwithstanding the fact that the actual transaction doctrine would prevent them from claiming the consequences of Form Two.[110]

Although the actual transaction doctrine is related to aspects of tax law regarding rescission of transactions, there is an important distinction between the actual transaction doctrine and tax law applicable to the rescission of transactions. On one hand, the IRS invokes the actual transaction doctrine when a taxpayer uses one form and argues that he or she could just as easily have used another form and, as a result, he or she ought to be able to claim the tax consequences of the non-selected form.[111] On the other hand, aspects of tax law regarding rescissions apply when a taxpayer first uses one form but subsequently employs the alternative form following a reversal of the original transaction.[112]

Further, the actual transaction doctrine only applies when the transaction used and the alternative transaction are equally true to the same underlying substance.[113] If the transaction used and the alternative transaction do not have the same underlying substance (because, for instance, they differ in many non-tax respects), the taxpayer could attempt to claim the tax consequences of the alternative transaction only if the taxpayer unwound the initial transaction and carried out the alternative transaction. Thus, in cases in which the transaction actually used and the alternative transaction lack the same underlying substance, the actual transaction doctrine is irrelevant, and limits on a taxpayer's ability to unwind a transaction for tax purposes hinder post-transactional tax decisions.

---

occurred had the parties originally undertaken Form Two. Furthermore, the transactions would result in even less favorable tax consequences than would follow if the parties decided to accept the tax consequences of Form One rather than trying to reverse the transaction. Reversing Form One causes recognition of additional tax gain, as well as a complete step-down in the basis of the building to fair market value even though not all of the built-in loss in the building is recognized.

109. *See supra* note 104 and accompanying text.

110. *See supra* Part I.B.1.

111. *See supra* Part I.B.

112. Because of this difference, the actual transaction doctrine and the rules regarding unwinding have different effects on the goal of fostering efficiency. *See infra* note 173 and accompanying text.

113. Accordingly, Form One and Form Two, as used in the unexpected economic outcome situation, are equally true to the underlying substance. *See supra* Part I.B.1.

D. A Parallel Concept: Limitations on the Retroactive Effect of Tax Elections

In many situations, a taxpayer can make an election that will affect the tax consequences of a transaction.[114] Elections available to taxpayers include: elections that determine how certain business entities are classified;[115] individual taxpayers' election to either claim the standard deduction or itemize deductions;[116] various partnership tax elections that determine how tax items are shared among partners[117] or that determine the tax consequences following transfers of partnership interests or partnership distributions;[118] and elections that affect the tax consequences of certain corporate acquisitions.[119]

Moreover, regardless of whether a tax election is made, the non-tax results of a transaction will remain the same.[120] In other words, due to a purely formal distinction, one transaction will lead to very different tax consequences than another transaction. The only difference between the transactions is that the taxpayer makes a particular tax election with respect to one transaction but does not make the same tax election with respect to the other transaction. Because the only dissimilarity between the transactions is one of form, a decision regarding whether to make a tax election is, essentially, another example of an opportunity to select among different transactional forms that

---

114. This Part I.D discusses explicit elections, or opportunities for a taxpayer to obtain different tax treatment without changing any of the non-tax features of his or her behavior or transactions. The examples in Part I.B are examples of implicit elections, or opportunities for a taxpayer to obtain different tax treatment by changing some non-tax features of his or her behavior or transactions. For further discussion of explicit tax elections see generally, Heather M. Field, *Choosing Tax: Explicit Elections as an Element of Design in the Federal Income Tax System*, 47 HARV. J. ON LEGIS. 21 (2010) and Edward Yorio, *The Revocability of Federal Tax Elections*, 44 FORDHAM L. REV. 463 (1976). For discussion of specific elections, see generally Karen C. Burke, *Repairing Inside Basis Adjustments*, 58 TAX LAW. 639 (2005) (discussing § 754); Emily Cauble, *Making Partnerships Work for Mom and Pop and Everyone Else*, 2 COLUM. J. TAX. L. 247 (2011) (discussing §§ 704(c) and 754); Laura Cunningham, *Use and Abuse of Section 704(c)*, 3 FLA. TAX REV. 93 (1996) (discussing § 704(c)); Laura E. Cunningham & Noel B. Cunningham, *Simplifying Subchapter K: The Deferred Sale Method*, 51 SMU L. REV. 1 (1997) (discussing § 704(c)); Andrea Monroe, *Saving Subchapter K: Substance, Shattered Ceilings, and the Problem of Contributed Property*, 74 BROOK. L. REV. 1381 (2009) (discussing § 704(c)); Joel Scharfstein, *An Analysis of the Section 704(c) Regulations*, 48 TAX LAW. 71 (1994) (discussing § 704(c)); George K. Yin, *The Taxation of Private Business Enterprises: Some Policy Questions Stimulated by the "Check-the-Box" Regulations*, 51 SMU L. REV. 125 (1997) (discussing entity classification elections).

115. Treas. Reg. § 301.7701-2.

116. I.R.C. § 63(b), (c), (e) (2006).

117. Treas. Reg. § 1.704-3.

118. I.R.C. § 754.

119. I.R.C. § 338.

120. *See, e.g.*, Field, *supra* note 114, at 30 ("Explicit elections, by definition, affect taxes only; they lack non-tax legal impact."); Yin, *supra* note 114, at 130 (mentioning that tax elections have "ramifications for tax purposes only").

lead to different tax consequences despite having the same underlying substance.

Moreover, taxpayers will often engage in tax planning at the pre-transactional stage to evaluate which election will lead to the most favorable tax consequences, at least with respect to a tax election that cannot be made retroactively. In addition, for precisely the same reasons that a taxpayer seeks to effectuate a post-transactional tax decision after selecting a particular transactional form, a taxpayer may also seek to change a tax election after a transaction has occurred.

In particular, there are three situations in which a taxpayer may want to retroactively modify a tax election. These situations are: (1) the unexpected economic outcome situation;[121] (2) the inadequate pre-transactional tax-planning situation;[122] and (3) the overly aggressive pre-transactional tax-planning situation.[123] These three situations correspond to the identically

---

121. In the unexpected economic outcome situation, existing rules prevent a taxpayer from retroactively modifying a tax election, at least in the case of some elections. For example, in the case of an entity classification election, the effective date of an election can be no earlier than seventy-five days before the election is filed. Treas. Reg. § 301.7701-3(c)(1)(iii) (2011). In some circumstances, the taxpayer will be granted relief to file an election later than seventy-five days after the desired effective date. Specifically, if the entity requests relief for a late classification election within three years and seventy-five days of the desired effective date, relief will automatically be granted if: (1) the entity failed to obtain its desired classification solely because the relevant form was not filed in a timely manner; (2) the entity has either not yet filed a tax return or has filed tax returns consistent with its desired classification; and (3) the entity has "reasonable cause" for its failure to timely file the election. *See* Rev. Proc. 2009-41, 2009-39 I.R.B. 440. These three requirements likely prevent a taxpayer from obtaining relief in an unexpected economic outcome situation. If the taxpayer is not entitled to automatic relief for filing a late election, the taxpayer must request a private letter ruling. *Id.* In such a case, the Treasury Regulations specifically provide that a taxpayer will not be entitled to file a late election if the taxpayer "uses hindsight." Treas. Reg. § 301.9100-3(b)(3)(iii). Elaborating on this statement, the regulations provide, "If specific facts have changed since the due date for making the election that make the election advantageous to a taxpayer, the IRS will not ordinarily grant relief. In such a case, the IRS will grant relief only when the taxpayer provides strong proof that the taxpayer's decision to seek relief did not involve hindsight." *Id.* Therefore, the regulations specifically prohibit late filing of an entity classification election as a means of carrying out a post-transactional tax decision in an unexpected economic outcome situation. *See* Schnabel, *supra* note 103, at 718–22 (providing additional discussion of post-transactional tax decisions in the context of entity classification).

122. In the inadequate pre-transactional tax-planning situation, in the case of some elections, a taxpayer cannot make his or her desired election retroactively. Furthermore, in some cases, relief is readily available when inadequate pre-transactional tax planning results in a failure to properly make an intended election. However, relief may be less obtainable when inadequate pre-transactional tax planning results in a failure to intend to make a favorable election. *See, e.g.*, Yorio, *supra* note 114, at 472–73.

123. In the overly aggressive pre-transactional tax-planning situation, a taxpayer makes a given election and employs overly aggressive tax planning in an attempt to achieve optimal tax consequences. The IRS successfully challenges the claimed tax consequences. In response to the IRS's challenge, the taxpayer retroactively seeks to alter the election. In the case of some elections, the taxpayer cannot retroactively modify the election. *See, e.g.*, Yorio, *supra* note 114,

named situations described in connection with the actual transaction doctrine.[124] Further, in all three situations, existing rules limit the taxpayer's ability to make post-transactional tax decisions, at least in the case of some elections.[125]

II. THE UNDESIRABILITY OF POST-TRANSACTIONAL TAX DECISIONS

As previously discussed, tax law is generally hostile to post-transactional tax decisions. This hostility may be designed to serve a number of underlying goals that have been offered as justification for a general aversion to tax planning. First, the law may seek to prevent post-transactional tax decisions to prevent tax revenue erosion. Second, the law may discourage post-transactional decisions to promote fairness. Finally, the law may inhibit post-transactional tax decisions to foster efficiency.

A. Preventing Tax Revenue Erosion

Tax law may limit post-transactional tax decisions as a way of preventing tax revenue erosion. Any tax decision, whether pre-transactional or post-transactional, can result in lower tax revenue collection than what would occur in the decision's absence because the object of tax decisions is to reduce a taxpayer's effective tax rate. Tax planning, as a whole, has been criticized because of its tax revenue reducing effects.[126] Due to the benefit of hindsight, taxpayers' post-transactional tax decisions would be more accurate than pre-transactional tax decisions. Thus, post-transactional tax decisions would lead to even more tax revenue reduction than pre-transactional tax decisions.

B. Promoting Fairness

Additionally, tax planning has been criticized because of its potential to undermine fairness in the tax system.[127] Particularly if sophisticated, well-advised taxpayers are more likely to engage in tax planning, discouraging

---

at 480–83 ("The courts have generally been antagonistic to taxpayer revocations in response to tax audits."). However, occasionally a court has allowed a taxpayer to revoke an election in such a case, at least when the court is convinced that the tax consequences challenged by the IRS were claimed by the taxpayer as a result of a good faith misunderstanding of resulting tax consequences. *See, e.g.*, Mamula v. Comm'r, 346 F.2d 1016, 1018–19 (9th Cir. 1965); Meyer's Estate v. Comm'r, 200 F.2d 592, 595–97 (5th Cir. 1952); Gentsch v. Goodyear Tire & Rubber Co., 151 F.2d 997, 1001 (6th Cir. 1945). These cases, in which a taxpayer succeeds, may be better characterized as cases involving inadequate pre-transactional tax planning rather than cases involving overly aggressive pre-transactional tax planning.

124. *See supra* Part I.B.

125. A complete discussion of retroactivity limitations on tax elections is beyond the scope of this Article. For further discussion of this topic, see generally Aubree L. Helvey & Beth Stetson, *The Doctrine of Election*, 62 TAX LAW. 335, 338 (2009) and Yorio, *supra* note 114.

126. *See, e.g.*, Blatt, *supra* note 75, at 394 (listing as one goal of the non-disavowal doctrine the need to preserve tax revenue); Schizer, *supra* note 5, at 1319.

127. *See, e.g.*, Field, *supra* note 114, at 23–24; Schizer, *supra* note 5, at 1319.

tax planning generally can promote fairness.[128] A fairer tax system is a worthy goal in and of itself because a fairer system can decrease wealth inequality. In addition, promoting fairness is desirable because it can increase the perception that the tax system is fair which, in turn, can foster improved tax compliance.[129]

Although this observation can justify discouraging all tax planning, it does not justify placing greater restrictions on post-transactional tax decisions than pre-transactional tax decisions.[130] In fact, disproportionately restricting post-transactional tax decisions subverts fairness by granting an even greater advantage to those who engage in effective pre-transactional tax decisions.[131]

Placing a premium on pre-transactional tax decisions is particularly troublesome because sophisticated taxpayers are much more likely than unsophisticated taxpayers to seek tax advice at the pre-transactional stage.[132] Unsophisticated taxpayers are not likely to seek advice at the pre-transactional stage because they are unaware that altering their decisions could significantly affect their tax liability.[133] By contrast, at the post-transactional stage, sophisticated and unsophisticated taxpayers are on more even ground because even unsophisticated taxpayers may seek tax advice at the tax return preparation stage and become aware of foregone opportunities to structure their activities in a different manner.[134] Therefore, restricting post-transactional tax decisions more than pre-transactional tax decisions could disproportionately harm unsophisticated taxpayers.

---

128. *See, e.g.*, Schizer, *supra* note 5, at 1319 ("Since wealthy and well advised taxpayers have an edge in planning, limiting [tax planning] can lead to a more equitable distribution of tax burdens.").

129. *See, e.g.*, *id.* (describing one effect of limiting tax planning as follows, "The average taxpayer's faith in the system is preserved, promoting voluntary compliance and the attendant savings in enforcement costs."); Leandra Lederman, *The Interplay Between Norms and Enforcement in Tax Compliance*, 64 OHIO ST. L.J. 1453, 1497 (2003) (describing how sanctions "may help maintain the average contribution level and thereby maintain contributions").

130. *See infra* Part III.

131. *See infra* Part III.B.2.

132. Moreover, even inadequate pre-transactional tax advice protects taxpayers because a taxpayer who receives faulty advice may be able to bring a malpractice action against his or her advisor for any errors that occur. *See, e.g.*, Victoria A. Levin, *The Substantial Compliance Doctrine in Tax Law: Equity vs. Efficiency*, 40 UCLA L. REV. 1587, 1615 (1993) (discussing how prohibiting taxpayers from correcting errors in tax elections is problematic because it will increase malpractice litigation, and it bars those who did not hire a tax advisor from being compensated for inadvertent errors). For discussion of the limitations of this protection, however, see *infra* note 189.

133. *See supra* note 10 and accompanying text.

134. *See* Cauble, *supra* note 114, at 285–86 (providing a similar discussion).

C. Fostering Efficiency

Scholars have criticized tax planning because it potentially creates inefficiency and wastes societal resources.[135] In particular, a taxpayer who engages in tax planning may select a transaction that generates a lower pre-tax return than an alternative transaction, creating less societal wealth than would be produced had the taxpayer chosen a different transaction.[136]

A numerical example illustrates this effect of tax planning. Assume in one transaction (Transaction A), a taxpayer would earn, over one year, a 14% pre-tax return, but a 12% after-tax return. By contrast, over the same time period, the taxpayer would earn a 15% pre-tax return, but a 10% after-tax return, by engaging in a different transaction (Transaction B). Assume both transactions involve similar risk. If the taxpayer engages in tax planning, he or she will consider tax consequences when evaluating the transactions and will likely opt for Transaction A because it maximizes the taxpayer's private wealth. From a societal standpoint, however, the choice to engage in Transaction A is wasteful. Investing $100 in Transaction A for one year yields a total of $114 instead of the $115 total from Transaction B. If the taxpayer engaged in Transaction A, he or she will pay only $2 in tax for a net profit of $12. When the taxpayer engages in Transaction B, he or she will pay $5 in tax for a net profit of $10. Therefore, although Transaction A generates more individual wealth, the total profit from Transaction A is $1 less than the total profit from Transaction B. These results are summarized in Table 1 below.

---

135. *See, e.g.*, Field, *supra* note 114, at 22–23 (generally, scholars conclude that tax planning is detrimental to societal welfare); Michael S. Knoll, *Tax Planning, Effective Marginal Tax Rates, and the Structure of the Income Tax*, 54 TAX L. REV. 555, 555 (2001) ("Tax planning not only creates harmful perceptions, it also is frequently harmful in its own right. . . . [T]ax planning leads taxpayers to invest in many projects that they would not undertake solely on the economics."); Schizer, *supra* note 5, at 1319 (stating that limiting tax planning reduces "social waste . . . as taxpayers refrain from tax motivated behavior"); David A. Weisbach, *Line Drawing, Doctrine, and Efficiency in Tax Law*, 84 CORNELL L. REV. 1627, 1632 (1999) [hereinafter Weisbach, *Line Drawing*] ("Taxing similar activities differently causes behavioral distortions . . . .").

136. Additionally, scholars have observed that tax planning is wasteful because the time and resources devoted to tax planning could be put to better, more productive uses. *See, e.g.*, Knoll, *supra* note 135, at 555–56 ("From a societal standpoint, it would be better simply to reduce taxes and redeploy the time and talent devoted to tax planning to other more productive pursuits."); Weisbach, *Ten Truths*, *supra* note 5, at 222 ("Nothing is gained by finding new ways to turn ordinary income into capital gain, to push a gain offshore, or to generate losses. No new medicines are found, computer chips designed, or homeless housed through tax planning.").

TABLE 1. NUMERICAL EXAMPLE OF EFFECTS OF TAX PLANNING

	TRANSACTION A	**TRANSACTION B**
Pre-Tax Return	14%	15%
Effective Tax Rate	14.29%	33.33%
After-Tax Return	12%	10%
$100 invested for one year:		
Total Profit	$14	$15
Tax Paid	$2	$5
Profit Retained by Taxpayer	$12	$10

Tax planning would be less prevalent if applicable laws were designed so that tax planning was less beneficial. In the example above, if Transaction A were subject to the same tax rate that applies to Transaction B, taxpayers would not benefit from tax planning. In particular, assume Transaction A is subject to the same 33.33% effective tax rate that applies to Transaction B and assume the pre-tax return generated by each transaction equals the pre-tax return shown in Table 1. The result is that Transaction B will generate a higher after-tax return than Transaction A. Specifically, the taxpayer would earn a 9.33% after-tax return by engaging in Transaction A, but a 10% after-tax return by engaging in Transaction B. Thus, the taxpayer will opt for Transaction B because it maximizes the taxpayer's private wealth. Moreover, from a societal standpoint, the selection of Transaction B is also advantageous. By engaging in Transaction B, the taxpayer earns $10 of net profit and pays $5 in tax. Instead, if the taxpayer engaged in Transaction A, the taxpayer would earn $9.33 of net profit and pay $4.67 in tax. Thus, the total profit generated from Transaction B ($10 retained by the taxpayer plus $5 paid in taxes or $15 in total) is more than the total profit that would have been generated from Transaction A ($9.33 retained by the taxpayer plus $4.67 paid in taxes or $14 in total). These results are summarized in Table 2 below.

TABLE 2. NUMERICAL EXAMPLE OF EFFECTS OF DISCOURAGING TAX PLANNING

	TRANSACTION A	**TRANSACTION B**
Pre-Tax Return	14%	15%
Effective Tax Rate	33.33%	33.33%
After-Tax Return	9.33%	10%
$100 invested for one year:		
Total Profit	$14	$15
Tax Paid	$4.67	$5
Profit Retained by Taxpayer	$9.33	$10

Notwithstanding the example above, discouraging tax planning has an unclear overall effect on efficiency. In particular, restricting some tax planning might undermine efficiency rather than foster it. Specifically, limiting certain tax planning strategies could encourage taxpayers to refocus their efforts on even more wasteful strategies.[137] For example, subjecting Transactions A and B to the same tax treatment will not improve overall efficiency if other available, comparable transactions continue to yield lower pre-tax returns but higher after-tax returns than Transactions A and B.[138]

---

137. *See, e.g.*, Schizer, *supra* note 5, at 1320 ("[E]ven if some planning is stopped, total planning waste could still increase if those who continue to plan face higher costs."); Weisbach, *Disrupting the Market*, *supra* note 5, at 972–74; Weisbach, *Line Drawing*, *supra* note 135, 1628–30, 1664–71; Weisbach, *Ten Truths*, *supra* note 5, at 239. *See generally* Philip A. Curry et al., *Creating Failures in the Market for Tax Planning*, 26 VA. TAX REV. 943 (2007) (discussing how policymakers face a trade-off when considering taking steps to attack current tax planning strategies, namely, the trade-off between (i) costs arising from taxpayers' use of those current tax planning strategies and (ii) costs arising from taxpayers' search for new tax planning strategies once the existing methods are attacked).

138. To demonstrate this, Table 3 shows Table 1 modified to include a third possible transaction, Transaction C. If the results of three transactions are as shown in Table 3 and if the transactions involve similar amounts of risk and otherwise are close substitutes for each other, the taxpayer will select Transaction A because it generates the highest after-tax return. From a societal standpoint, this choice is not optimal because Transaction A generates a lower pre-tax return than Transaction B, but Transaction A is preferable to Transaction C from a societal standpoint.

TABLE 3.

	TRANSACTION A	**TRANSACTION B**	**TRANSACTION C**
Pre-Tax Return	14%	15%	13%
Effective Tax Rate	14.29%	33.33%	20%
After-Tax Return	12%	10%	10.40%
$100 invested for one year:			
Total Profit	$14	$15	$13
Tax Paid	$2	$5	$2.60
Profit Retained by Taxpayer	$12	$10	$10.40

Assume Transactions A and B are subject to the same effective tax rate and that Transaction C is a ready substitute for Transactions A and B. As shown in Table 4, Transaction C generates the highest after-tax return. Consequently, the taxpayer engages in Transaction C, which is wasteful from a societal standpoint. Given that Transaction C's pre-tax return is lower than Transaction A's pre-tax return, discouraging taxpayers from choosing Transaction A forces taxpayers into Transaction C, an even more wasteful transaction, thereby undermining the goal of improving efficiency.

In summary, the effects that curbing tax planning have on efficiency are generally unclear and dependent on the surrounding circumstances. Likewise, restricting post-transactional tax decisions has unclear ramifications with respect to fostering efficiency.[139]

III. There are Preferable Ways to Address the Concerns Underlying the Restrictions on Post-Transactional Tax Decisions

As discussed in Part II, tax laws may deter post-transactional tax decisions as a means of serving several underlying goals, including: preventing tax revenue erosion, promoting fairness, and fostering efficiency. In many cases, all three goals would be better served by rationalizing the law. In other words, the goals would be better served by eliminating situations in which similar forms of a given transaction receive different tax treatment.[140] However, rationalizing the law may be infeasible in many instances.[141] Thus, different transactional forms will continue to receive different tax treatment in some cases, and reforms other than rationalizing the law must be explored.

A. The Unexpected Economic Outcome Situation

In the unexpected economic outcome situation, a taxpayer selects a given transactional form because it will lead to the most beneficial tax consequences given the expected economic outcome of the transaction.[142] However, the economic outcome of the transaction proves to be different than expected, and, thus, the taxpayer would have been able to achieve more favorable tax consequences had he or she used an alternative form.[143] Because of the actual transaction doctrine, the taxpayer cannot claim the tax consequences that would have resulted from the alternative form.[144]

Table 4.

	Transaction A	**Transaction B**	**Transaction C**
Pre-Tax Return	14%	15%	13%
Effective Tax Rate	33.33%	33.33%	20%
After-Tax Return	9.33%	10%	10.40%
$100 invested for one year:			
Total Profit	$14	$15	$13
Tax Paid	$4.67	$5	$2.60
Profit Retained by Taxpayer	$9.33	$10	$10.40

139. *See infra* Parts III.A.3, III.C.3.
140. *See infra* Part IV.B.
141. *See infra* Part IV.B; *see also infra* note 195.
142. *See supra* Part I.B.1 (discussing further the unexpected economic outcome situation).
143. *See supra* Part I.B.1 (discussing further the unexpected economic outcome situation).
144. *See supra* Part I.B.1 (discussing further the unexpected economic outcome situation).

In the unexpected economic outcome situation, the actual transaction doctrine prevents tax revenue erosion but has murkier effects on the goals of promoting fairness and fostering efficiency. The actual transaction doctrine should still apply in this case, however, because the doctrine prevents tax revenue erosion and does not seriously undermine fairness, and it is not of primary importantance with regard to efficiency.

1. Preventing Tax Revenue Erosion

In the unexpected economic outcome situation, the actual transaction doctrine prevents tax revenue erosion. Without the actual transaction doctrine, taxpayers would not only be able to engage in pre-transactional tax planning to reduce expected tax revenues but could also achieve favorable tax consequences should their economic projections turn out to be inaccurate.

2. Promoting Fairness

In the unexpected economic outcome situation, the actual transaction doctrine limits the post-transactional tax decisions of a taxpayer who engaged in pre-transactional tax planning. Consequently, applying the doctrine in this situation does not penalize a taxpayer simply because he or she did not conduct adequate pre-transactional tax planning. Thus, in the unexpected economic outcome situation, applying the actual transaction doctrine does not always favor taxpayers who are savvier tax planners. Applying the doctrine in this situation does, however, reward sophisticated persons in a different respect. In particular, persons who accurately predict the economic results of their transactions will pay less in tax than persons who inaccurately predict the economic results of their transactions. Thus, to the extent that sophisticated persons tend to predict more exactly the economic results of their transactions, sophisticated persons disproportionately benefit from current rules. Consequently, the actual transaction doctrine could be criticized for causing unfairness in the unexpected economic outcome situation. Although this criticism has some merit, at least two factors ameliorate the fairness concerns that arise when applying the doctrine in this situation.

First, unfairness is problematic, in part, because it contributes to the perception that the tax system is unfair, and that perception can undermine voluntary tax compliance.[145] Generally, the type of disparity thought to contribute to the perception that the system is unfair arises when taxpayers benefit from greater expertise with respect to tax law.[146] The public's trust in the tax system is undermined by the perception that taxation is easily avoidable as long as a taxpayer knows the right loopholes.[147] By contrast, the view that

145. *See supra* note 129 and accompanying text.

146. *See supra* note 129.

147. *See* Knoll, *supra* note 135, at 555 ("The specter of wealthy individuals and large corporations hiring legions of high-priced lawyers and accountants to develop and implement tax saving strategies creates the perception that the system is unfair.").

taxpayers can pay less tax if they more accurately predict the economic outcome of their transactions is less likely to contribute to harmful perceptions of the tax system. This type of disparity does not involve sophisticated taxpayers benefiting from tax loopholes. Rather, this disparity involves taxpayers achieving greater success when they more precisely predict the results of their businesses and, regardless of the tax rules, the public likely accepts the unavoidable conclusion that people who make better economic predictions will be more prosperous.

Second, from a fairness perspective, if current rules continue to limit post-transactional tax decisions in the inadequate pre-transactional tax-planning situation, it is crucial for the rules to continue to apply in the unexpected economic outcome situation.[148] If the rules applied in the former situation but not in the latter, taxpayers with more sophisticated tax knowledge would not only benefit disproportionately from the opportunity to engage in tax planning before a transaction, but, if they happened to predict wrongly the economic outcome of their transactions, they would also be afforded a second chance. Such a system would bestow even greater benefits on taxpayers who are sophisticated with respect to tax planning.

In summary, although applying the actual transaction doctrine in the unexpected economic outcome situation raises some fairness concerns, these concerns are not overly troubling and, thus, do not justify altering the application of the doctrine in this situation.

3. Fostering Efficiency

As discussed above, tax planning can breed inefficiency because tax consequences can distort taxpayers' decisions so that they select transactions that generate lower pre-tax returns than alternative, comparable transactions.[149] Applying the actual transaction doctrine in the unexpected economic outcome situation, however, has unclear effects on the tendency of taxpayers to select transactions that generate lower pre-tax returns than alternative transactions. In some cases, the actual transaction doctrine may mitigate inefficiency,[150] but, in others cases, the doctrine might have no effect on inefficiency,[151] and, in still other cases, the doctrine can actually exacerbate inefficiency.[152]

148. Moreover, even if the reforms proposed in this Article were adopted, post-transactional tax decisions would not always be available to taxpayers who fail to adequately plan before engaging in a transaction. For instance, if a taxpayer chooses a non-optimal transactional form because of a failure to adequately plan ahead of time and the taxpayer does not discover the mistake until after he or she has filed tax returns reporting the results from the transactional form actually used, the proposed reforms would offer no relief. *See infra* Part IV.A. Likewise, if a doctrine other than the actual transaction doctrine prevents a given post-transactional tax decision, this Article's proposed reforms would provide no assistance.

149. *See supra* Part II.C.

150. *See infra* Part III.A.3.a.

151. *See infra* Part III.A.3.b.

152. *See infra* Part III.A.3.c.

Moreover, other aspects of tax law likely dominate tax planning decisions so that these other aspects have greater effects than the actual transaction doctrine on the tendency of taxpayers to select transactions that generate lower pre-tax returns than alternative transactions.[153]

a. Sometimes the Actual Transaction Doctrine Helps

In certain situations, the actual transaction doctrine can mitigate the inefficiency resulting from tax consequences distorting taxpayers' decisions. To illustrate, imagine a taxpayer contemplating a transaction that could be structured in either of two ways. The first approach (Form One) generates a slightly lower pre-tax return than the second approach (Form Two).

The effective tax rate for each option depends on the economic outcome of the transaction.[154] Assume that there are two possible economic outcomes of the transaction. The taxpayer expects the first outcome (Likely Outcome), but the taxpayer understands the potential for another outcome (Unlikely Outcome). In the event of the Likely Outcome, Form One subjects the taxpayer to a lower effective tax rate than Form Two. In the event of the Unlikely Outcome, Form Two subjects the taxpayer to a lower effective tax rate than Form One. Table 5 summarizes the results assuming the actual transaction doctrine applies. The effective tax rates provided in Table 5 and subsequent tables are not based on specific transactions. However, given that effective tax rates depend on many aspects of a transaction, such as the character of income that it generates, and on many features of the taxpayer, including income and losses arising from other sources,[155] the effective tax rates listed could plausibly arise from real transactions.

153. *See infra* Part III.A.3.d.

154. *See supra* Part I.B.1 (providing an example of how the tax consequences of a given transactional form can depend on the transaction's economic outcome).

155. *See, e.g.*, Knoll, *supra* note 135, at 557–58 (describing how items of income are taxed at different effective rates because of the existence of various tax advantaged assets and because of taxpayer-specific features such as net operating loss carry-forwards).

TABLE 5. RESULTS WITH ACTUAL TRANSACTION DOCTRINE

	FORM ONE			FORM TWO		
	Pre-tax Return	Effective Tax Rate	After-tax Return	Pre-tax Return	Effective Tax Rate	After-tax Return
Likely Outcome (70% chance)	14%	19%	11.34%	15%	25%	11.25%
Unlikely Outcome (30% chance)	4.9%	30%	3.43%	5%	0%	5%
Expected Pre-tax Return	70% (14%) + 30% (4.9%) = 11.27%			70% (15%) + 30% (5%) = 12%		
Expected After-tax Return	70% (11.34%) + 30% (3.43%) = 8.97%			70% (11.25%) + 30% (5%) = 9.38%		

Table 5 reflects the application of the actual transaction doctrine. By contrast, Table 6 shows the results of the same example, absent the actual transaction doctrine. The only difference between the two tables is the effective tax rate of Form One if the Unlikely Outcome occurs. If not for the actual transaction doctrine and if the Unlikely Outcome occured, the taxpayer could claim that he or she was entitled to the tax consequences that would have followed from Form Two because he or she could have used that form. As a result, if not for the actual transaction doctrine, the effective tax rate of Form One if the Unlikely Outcome occurred would be the same as the effective tax rate of Form Two.

This example demonstrates that the actual transaction doctrine can, in some cases, increase the likelihood of the taxpayer adopting a form that generates a higher pre-tax return. As shown in Table 5, under the actual transaction doctrine, Form One leads to a lower expected after-tax return than Form Two. In particular, Form One leads to an expected after-tax return of 8.97%, while Form Two results in an expected after-tax return of 9.38%. Thus, when selecting between the two forms, the savvy taxpayer will choose Form Two. Moreover, opting for Form Two rather than Form One is also beneficial from a societal standpoint because Form Two generates a higher expected pre-tax return (12% versus 11.27%).

In contrast, without the actual transaction doctrine, Form One would lead to a higher expected after-tax return than Form Two, as shown in Table 6. In particular, without the doctrine, Form One would produce an expected after-tax return of 9.41% while Form Two would yield an expected after tax-return of 9.38%. Consequently, without the actual transaction doctrine, the sophisticated taxpayer would opt for Form One and this choice would not be advantageous from a societal standpoint because Form One generates a lower expected pre-tax return (11.27% versus 12%).[156]

TABLE 6. RESULTS WITHOUT ACTUAL TRANSACTION DOCTRINE

	FORM ONE			**FORM TWO**		
	Pre-tax Return	Effective Tax Rate	After-tax Return	Pre-tax Return	Effective Tax Rate	After-tax Return
Likely Outcome (70% chance)	14%	19%	11.34%	15%	25%[157]	11.25%
Unlikely Outcome (30% chance)	4.9%	0%	4.9%	5%	0%	5%
Expected Pre-tax Return	70% (14%) + 30% (4.9%) = 11.27%			70% (15%) + 30% (5%) = 12%		
Expected After-tax Return	70% (11.34%) + 30% (4.9%) = 9.41%			70% (11.25%) + 30% (5%) = 9.38%		

In summary, from a societal standpoint, the taxpayer makes a more beneficial choice than that chosen by the taxpayer if the actual transaction doctrine did not apply in the unexpected economic outcome situation under the facts reflected in Tables 5 and 6.

b. Sometimes the Actual Transaction Doctrine Does Not Matter

In some cases, the actual transaction doctrine will have no effect on the tendency of tax consequences to distort taxpayers' decisions.[158] This can be

156. *See supra* Part II.C.

157. Even if the actual transaction doctrine did not apply in the unexpected economic outcome situation, this rate remains 25% rather than 19% (the effective tax rate of Form One), assuming that the doctrine continues to apply in the inadequate pre-transactional tax-planning situation. If a taxpayer selects Form Two rather than Form One, the facts would be those of an inadequate pre-transactional tax-planning situation given that the taxpayer would have selected the form that yields a lower after-tax return if the transaction produces its expected economic outcome. If the actual transaction doctrine was eliminated entirely, this rate would be 19% rather than 25%.

158. This could also be the case in situations where the alternative forms of the transaction generate the same pre-tax return. In some cases, pre-tax returns will be different. For instance, in the example in Part I.B.1, pre-tax returns could be different if the non-tax expenses associated with Form One were higher than those expenses incurred under Form Two. In other cases, both the form used and the alternative form will generate identical pre-tax returns. This would be true when the only difference between the two forms is whether the taxpayer has made a given tax election. However, even if the pre-tax returns of different transactional forms are identical, limitations on post-transactional tax decisions can affect efficiency. In particular, limitations on post-transactional tax decisions could decrease the after-tax returns of both of the forms, which could, in turn, prompt a taxpayer to engage in an entirely different transaction. From an efficiency standpoint, this result would be positive if the different transaction yielded a higher pre-tax return, but negative if the different transaction produced a lower pre-tax return.

illustrated by slightly changing the assumptions used in Tables 5 and 6. Tables 7 and 8 illustrate the results under these new assumptions both with and without the actual transaction doctrine.

Table 7 reveals the results with the actual transaction doctrine. The Table demonstrates that even with the doctrine, tax consequences distort the taxpayer's choice. In particular, the taxpayer will opt for Form One because it generates a higher expected after-tax return than Form Two (9.73% versus 9.38%). From a societal standpoint, this decision is not optimal because Form Two yields a higher expected pre-tax return than Form One (12% versus 11.27%).[159]

TABLE 7. RESULTS WITH ACTUAL TRANSACTION DOCTRINE

	FORM ONE			**FORM TWO**		
	Pre-tax Return	Effective Tax Rate	After-tax Return	Pre-tax Return	Effective Tax Rate	After-tax Return
Likely Outcome (70% chance)	14%	15%	11.90%	15%	25%	11.25%
Unlikely Outcome (30% chance)	4.9%	5%	4.66%	5%	0%	5%
Expected Pre-tax Return	70% (14%) + 30% (4.9%) = 11.27%			70% (15%) + 30% (5%) = 12%		
Expected After-tax Return	70% (11.90%) + 30% (4.66%) = 9.73%			70% (11.25%) + 30% (5%) = 9.38%		

In contrast, Table 8 details the results without the actual transaction doctrine. With this change, the taxpayer would still select Form One because it would produce a higher expected after-tax return than Form Two (9.80% versus 9.38%).

159. *See supra* Part II.C (discussing why an investment that generates a lower pre-tax return is not optimal from a societal point of view).

TABLE 8. RESULTS WITHOUT ACTUAL TRANSACTION DOCTRINE

	FORM ONE			FORM TWO		
	Pre-tax Return	Effective Tax Rate	After-tax Return	Pre-tax Return	Effective Tax Rate	After-tax Return
Likely Outcome (70% chance)	14%	15%	11.90%	15%	25%[160]	11.25%
Unlikely Outcome (30% chance)	4.9%	0%	4.9%	5%	0%	5%
Expected Pre-tax Return	70% (14%) + 30% (4.9%) = 11.27%			70% (15%) + 30% (5%) = 12%		
Expected After-tax Return	70% (11.90%) + 30% (4.9%) = 9.80%			70% (11.25%) + 30% (5%) = 9.38%		

The examples in Tables 7 and 8 reveal that, in the unexpected economic outcome situation, the actual transaction doctrine sometimes has no effect on a taxpayer's decision to select a transactional form that yields a lower expected pre-tax return than an alternative transaction. Consequently, in some cases, the actual transaction doctrine has no effect on the tendency of tax consequences to distort taxpayers' decisions.

c. Sometimes the Actual Transaction Doctrine Causes Harm

In some cases, the actual transaction doctrine can exacerbate inefficiencies. To illustrate, imagine a taxpayer who contemplates engaging in a transaction (Transaction A), which could be structured in one of two ways. The first method (Form One) generates a slightly lower pre-tax return than the second method (Form Two). Tables 5 and 6 show the results of the transaction, with and without the actual transaction doctrine. The relevant numbers to compare in these tables are also summarized in Table 9. As Table 9 shows, Transaction A Form Two generates a higher expected pre-tax return than Transaction A Form One (12% versus 11.27%). Taking into account the actual transaction doctrine, Transaction A Form Two also produces a higher expected after-tax return than Transaction A Form One (9.38% versus 8.97%). However, while Transaction A Form Two would still yield a higher pre-tax return than Transaction A Form One, if it were not for the actual transaction doctrine, the

160. Even if the actual transaction doctrine did not apply in the unexpected economic outcome situation, this rate remains 25% rather than 15% (the effective tax rate of Form One), assuming the doctrine continues to apply in the inadequate pre-transactional tax-planning situation. If a taxpayer selects Form Two rather than Form One, the facts would be those of an inadequate pre-transactional tax-planning situation because the taxpayer would have selected the form that yields a lower after-tax return if the transaction produces its expected economic outcome. If the actual transaction doctrine were entirely eliminated, this rate would be 15% rather than 25%.

taxpayer would expect a higher after-tax return as a result of investing in Transaction A Form One (9.41% versus 9.38%).

In addition to the facts described above, assume, instead of executing Transaction A, the taxpayer could carry out a different transaction entirely, namely Transaction B. Transactions A and B involve similar amounts of risk. The expected pre-tax return of Transaction B is 11%. The expected after-tax return of Transaction B is 9.40%. Table 9 also includes the results of Transaction B.

TABLE 9. EFFECT OF ACTUAL TRANSACTION DOCTRINE

	WITH ACTUAL TRANSACTION DOCTRINE		
	Transaction A Form One	Transaction A Form Two	Transaction B
Expected Pre-tax Return	11.27%	12%	11%
Expected After-tax Return	8.97%	9.38%	9.40%
	WITHOUT ACTUAL TRANSACTION DOCTRINE		
	Transaction A Form One	Transaction A Form Two	Transaction B
Expected Pre-tax Return	11.27%	12%	11%
Expected After-tax Return	9.41%	9.38%[161]	9.40%

161. If the actual transaction doctrine were entirely eliminated (rather than modified so that it no longer applied in the unexpected economic outcome situation), this rate would be 10% rather than 9.38%. Ten percent is what results if, in Table 6, 19% (rather than 25%) is the effective tax rate for Form Two in the event of the Likely Outcome. *See supra* note 160. Even compared to a system eliminating the doctrine, the actual transaction doctrine could either cause a positive or negative effect depending on the facts assumed for Transaction B. For example, under the facts assumed in Table 9, if the actual transaction doctrine were entirely eliminated, the taxpayer would select Transaction A Form Two given that its expected after-tax return (10%) would be higher than the expected after-tax returns of the alternative transactions. Once the doctrine is applied, the taxpayer would select Transaction B, given that its expected after-tax return (9.40%) is higher than the expected after-tax returns of the alternative transactions. Thus, under the facts in Table 9, applying the actual transaction doctrine undermines efficiency, compared to a system in which the doctrine was entirely eliminated. If the facts in Table 9 were changed such that the expected pre-tax return of Transaction B was 13%, then applying the doctrine would have a positive effect, compared to a world in which the doctrine did not exist at all. Specifically, the taxpayer would still select Transaction B in a world with the doctrine, rather than Transaction A Form Two. However, this change would be positive, rather than negative, in a case in which Transaction B's expected pre-tax return is higher than that of Transaction A Form Two, the transaction selected without the doctrine.

As Table 9 reflects, without the actual transaction doctrine, the taxpayer would opt for Transaction A Form One that yields an expected after-tax return of 9.41%, which is higher than the expected after-tax return of either of the alternative transactions (9.38% or 9.40%). This selection does not optimize the benefit to society because Transaction A Form One's expected pre-tax return of 11.27% is lower than that of Transaction A Form Two at 12%. However, society benefits more from the taxpayer's choice than Transaction B, which yields an expected pre-tax return that is even lower than that of Transaction A Form One (11% versus 11.27%). Once the actual transaction doctrine is factored into the analysis, the taxpayer adopts Transaction B because it generates the highest expected after-tax return (9.40% compared to 8.97% and 9.38%). Thus, the application of the actual transaction doctrine results in a pre-transactional tax decision that is even more inefficient given that the taxpayer's chosen transaction produces a lower expected pre-tax return than the transaction the taxpayer would have used if the actual transaction doctrine did not apply.

d. Summary: The Goal of Fostering Efficiency

In the unexpected economic outcome situation, the actual transaction doctrine has unclear effects on the goal of increasing efficiency. In some cases, the doctrine can further the goal or at minimum do no harm. However, in other cases, the doctrine can undermine the goal of efficiency.

Specifically, the actual transaction doctrine undermines the goal of efficiency when the doctrine encourages taxpayers to engage in other, more wasteful forms of tax planning. Whether this result is likely to occur depends on the availability of alternative tax planning strategies, which, in turn, depends on at least two factors. First, these even more wasteful tax planning strategies will be less readily available in situations where the substance-over-form doctrine, and similar rules, effectively foreclose such strategies.[162] For instance, in the example in Table 9, if Transaction B would be recharacterized as Transaction A based on substance-over-form principles, then Transaction B would not have a higher after-tax return than Transaction A, even under the actual transaction doctrine. As a result, the doctrine would not cause the harm illustrated in Table 9. Second, wasteful decision-making is less likely to the extent that transactions with similar non-tax features receive similar tax treatment. For instance, the harm shown in Table 9 is more likely to occur if Transaction B is a ready substitute for Transaction A. However, if transactions that were ready substitutes received similar tax treatment and if Transaction B were a close alternative to Transaction A, then in Table 9, Transaction B would be subject to the same effective tax rate as Transaction A. Consequently, Transaction B would produce a lower expected after-tax return

162. *See supra* notes 5, 14–22 and accompanying text (providing discussion of the substance-over-form doctrine and similar rules).

than either form of Transaction A, thereby preventing the harm shown in Table 9.

Overall, factors other than the actual transaction doctrine, such as the effectiveness of the substance-over-form doctrine and the extent to which close substitutes are taxed similarly, likely have much stronger effects on taxpayers' decision-making than the effects caused by limitations on post-transactional tax decisions. This is particularly true because some taxpayers may not even consider the tax consequences that will result from a transaction if it produces an unexpected economic outcome. For these taxpayers, applying the actual transaction doctrine in the unexpected economic outcome situation has no effect on tax planning decisions.

B. The Inadequate Pre-Transactional Tax-Planning Situation

In the inadequate pre-transactional tax-planning situation, before engaging in a transaction, a taxpayer does not obtain tax advice or receives faulty tax advice.[163] Accordingly, the taxpayer is unaware that he or she could obtain more beneficial tax results by choosing an alternative transactional form.[164] After the transaction has begun, the taxpayer discovers the error and tries to claim the tax results that would have followed from using the alternative form.[165] The IRS can challenge this claim by invoking the actual transaction doctrine.[166]

In the inadequate pre-transactional tax planning situation, the actual transaction doctrine furthers the goal of preventing tax revenue erosion.[167] However, applying the doctrine in this situation undermines the goal of promoting fairness and has minimal effects on the goal of fostering efficiency.[168] Thus, the actual transaction doctrine should no longer apply in the inadequate pre-transactional tax planning situation provided that certain requirements are met.[169]

1. Preventing Tax Revenue Erosion

In the inadequate pre-transactional tax-planning situation, the actual transaction doctrine prevents tax revenue erosion. Without the doctrine, taxpayers could not only engage in pre-transactional tax planning that minimizes tax revenue collected, but, if they failed to obtain proper advice beforehand, they could obtain advice afterward and achieve the same favorable

163. *See supra* Part I.B.2.
164. *See supra* Part I.B.2.
165. *See supra* Part I.B.2.
166. *See supra* Part I.B.2.
167. *See infra* Part III.B.1.
168. *See infra* Part III.B.2–3.
169. *See infra* Part IV.A (discussing this proposal in detail). This analysis assumes that lost tax revenue would be recouped in ways that were not any worse, from a fairness perspective, than current rules.

tax consequences. In other words, applying the actual transaction doctrine in the inadequate pre-transactional tax planning situation collects additional tax revenue by levying more tax upon taxpayers who fail to effectively utilize pre-transactional tax planning.

2. Promoting Fairness

From a fairness perspective, the actual transaction doctrine is most troubling when applied in the inadequate pre-transactional tax-planning situation. In this situation, the doctrine favors taxpayers simply because they engage in effective pre-transactional tax planning. As discussed above, particularly at the pre-transactional stage, sophisticated taxpayers are more likely to engage in tax planning than unsophisticated taxpayers.[170] Consequently, calling upon the doctrine in this situation disproportionately benefits sophisticated taxpayers.

3. Fostering Efficiency

The actual transaction doctrine as applied in the inadequate pre-transactional tax-planning situation has minimal effects on the goal of fostering efficiency. Any effects that the doctrine does have undermine the efficiency goal. In order to illustrate this observation, two groups of taxpayers need to be analyzed separately: first, the taxpayers who do not engage in adequate pre-transactional tax planning under current law, and second, the taxpayers who do.

a. Taxpayers Who Do Not Tax Plan Currently

Some taxpayers fail to engage in adequate pre-transactional tax planning, despite the existence of limitations on post-transactional tax decisions. Even if these limitations were relaxed, the current non-tax planners would still not engage in pre-transactional tax planning.[171] Thus, with respect to this group of taxpayers, removing the actual transaction doctrine in the inadequate pre-transactional tax-planning situation would not increase their pre-transactional tax decisions but would only increase their post-transactional tax decisions.

As discussed above, tax planning can cause inefficiency because tax consequences can distort taxpayers' decisions such that they select transactions that generate lower pre-tax returns than alternative, comparable transactions.[172] This effect of tax planning is not applicable in the context of post-transactional

170. *See supra* notes 132–34 and accompanying text.

171. If anything, taxpayers would be less inclined to use pre-transactional tax planning if its benefits were eroded by increased opportunities to make tax decisions after a transaction.

172. *See supra* Part II.C.

tax decisions foreclosed by the actual transaction doctrine.[173] Pre-transactional tax decisions can result in a taxpayer undertaking a transaction that differs from what the taxpayer would have chosen for non-tax reasons. If a taxpayer does not engage in planning at the pre-transactional stage, the taxpayer will select a transaction based upon non-tax factors alone and, therefore, will tend to choose a transaction that generates a higher pre-tax return than comparable, alternative transactions, thus fostering efficiency. In the inadequate pre-transactional tax-planning situation, when a taxpayer attempts to engage in the type of post-transactional tax decision prevented by the actual transaction doctrine, the taxpayer is not attempting to alter the transaction in which he or she engaged.[174] The taxpayer does not alter the transaction used because a post-transactional tax decision that is prevented by the actual transaction doctrine merely revises how a transaction is reported.[175] Therefore, the taxpayer is not attempting to carry out a transaction other than the one he or she selected for non-tax reasons. As discussed, relaxing the rules in the inadequate pre-transactional tax-planning situation would cause taxpayers to make more post-transactional tax decisions but would not cause taxpayers to make more pre-transactional tax decisions. Ultimately, reforming the rules in

173. This is the case because post-transactional tax decisions that are limited by the actual transaction doctrine merely involve revising how a transaction is reported. *See infra* note 175 and accompanying text. By contrast, post-transactional tax decisions that are limited by rules regarding unwinding transactions, for example, could cause inefficiency because such decisions involve undertaking a transaction that differs from the transaction that the taxpayer initially undertook. *See supra* note 112 and accompanying text.

174. *See supra* notes 111–13 and accompanying text.

175. As discussed previously, the actual transaction doctrine is the roadblock in a taxpayer's way when the alternative transaction and the transaction actually used are equally true to the same underlying substance. *See supra* notes 111–13 and accompanying text. Thus, the transaction used and the alternative transaction are similar for non-tax purposes. Given this similarity, one might question whether a pre-transactional tax decision to engage in the alternative transaction could be inefficient. In other words, if the transaction chosen and the alternate transaction are similar, they may generate the same pre-tax returns so that a choice of one over the other would not generate inefficiency. However, in some instances, the two transactions will generate different pre-tax returns despite the fact that the transactions are very similar. In the example previously shown in Figures 1 and 2, Form One could involve some non-tax costs not associated with Form Two. For example, when using Form One, in order to obtain additional liability protection, Mr. Cash might form a limited liability company (an LLC) and have the LLC acquire the 10% interest in the assets, rather than directly acquiring the 10% interest in the assets. In the case of Form Two, because Mr. Cash never acquires the assets directly, forming an LLC would be unnecessary. Forming the LLC would involve some additional non-tax costs, and, thus, Form One would generate a slightly lower pre-tax return than Form Two. However, even if the LLC is used in Form One, Forms One and Two are still comparable from a tax perspective because the LLC would be disregarded as separate from Mr. Cash for tax purposes. If it were not for the actual transaction doctrine, a taxpayer who does not consider tax consequences ahead of time could use Form Two, which generates a higher pre-tax return, later discover that Form One would have led to more favorable tax consequences, and therefore report the results of Form One without actually engaging in the transaction using that form, and, therefore, without engaging in a transaction that generates a lower pre-tax return.

this manner would not cause taxpayers to more frequently select transactions that generate lower pre-tax returns than alternative, comparable transactions. In summary, with respect to taxpayers who currently fail to engage in pre-transactional tax planning, applying the actual transaction doctrine in the inadequate pre-transactional tax-planning situation has a minimal effect on the goal of fostering efficiency.

b. Taxpayers Who Currently Tax Plan

Many taxpayers who currently utilize pre-transactional tax planning would continue to do so even if the actual transaction doctrine was not applied in the inadequate pre-transactional tax-planning situation. In particular, given the other limitations on post-transactional tax decisions (such as constraints on the ability to unwind a transaction for tax purposes), taxpayers who currently tax plan beforehand would likely continue to do so even if the actual transaction doctrine did not apply in the inadequate pre-transactional tax-planning situation. Thus, applying the doctrine in this situation has little effect on the inefficiency produced by taxpayers who engage in pre-transactional tax planning.

Moreover, if no longer applying the actual transaction doctrine were to have any effect at all on taxpayers who currently plan, one would expect these taxpayers to engage in less, and not more, pre-transactional tax planning. This effect of limiting the doctrine is plausible because taxpayers would be able to make post-transactional tax decisions to compensate for a lack of pre-transactional tax planning and, thus, may view pre-transactional tax planning as less necessary. From the perspective of efficiency, this may be a positive result because pre-transactional tax planning can undermine the goal of fostering efficiency.[176]

Consequently, with respect to taxpayers who engage in pre-transactional tax planning under current law, applying the actual transaction doctrine in the inadequate pre-transactional tax-planning situation has minimal effects on the goal of fostering efficiency but, if anything, may undermine this goal.

C. The Overly Aggressive Pre-Transactional Tax-Planning Situation

In the overly aggressive pre-transactional tax-planning situation, the taxpayer opts for a given form of a transaction (Form Three) in an attempt to attain optimal tax consequences.[177] The IRS challenges the form the taxpayer used as not adequately reflecting the substance of the transaction and assesses some amount of additional tax.[178] In response, the taxpayer attempts to claim the tax consequences that would have resulted from an alternative form of the

176. *See supra* note 175.
177. *See supra* Part I.B.3.
178. *See supra* Part I.B.3.

transaction (Form One).[179] The alternative form leads to more favorable tax consequences than those that would follow from a successful challenge by the IRS, but less favorable tax consequences than what the taxpayer originally claimed.[180] Even though the effects on efficiency are not entirely clear, the actual transaction doctrine should still apply in the overly aggressive pre-transactional tax-planning situation because the doctrine prevents tax revenue erosion and promotes fairness.

1. *Preventing Tax Revenue Erosion*

In the overly aggressive pre-transactional tax-planning situation, the actual transaction doctrine can prevent tax revenue erosion in two ways. First, the doctrine deters taxpayers from engaging in overly aggressive pre-transactional tax planning. Second, the doctrine collects more tax revenue from taxpayers who are undeterred.

Regarding deterrence, without the actual transaction doctrine, taxpayers may be more inclined to opt for Form Three because, if the results they claimed were challenged, they could still obtain the tax results of Form One.[181] However, given the existence of the actual transaction doctrine, one cost of engaging in overly aggressive tax planning, such as picking Form Three, is foregoing the opportunity to engage in less aggressive tax planning, for example, by selecting Form One in lieu of Form Two. In this way, the actual transaction doctrine imposes an implicit penalty upon taxpayers who undertake overly aggressive tax planning that the IRS challenges.[182] This implicit penalty will discourage taxpayers from using such risky tax planning, thus resulting in additional revenue collection from taxpayers who might otherwise utilize such planning without being audited or challenged.

The actual transaction doctrine also increases tax revenue by imposing greater tax liability on taxpayers who are undeterred from engaging in overly aggressive tax planning.[183] In the aforementioned example, if a taxpayer was able to claim the tax consequences that would have resulted from Form One, he or she would owe less tax liability than what he or she would owe if the transaction is determined to lead to the less favorable tax consequences that follow from the IRS recharacterizing Form Three as Form Two.

---

179. *See supra* Part I.B.3.

180. *See supra* Part I.B.3.

181. *See* Hasen, *supra* note 98, at 935 (describing a similar situation that could arise if a taxpayer attempts to unwind a transaction in response to a challenge by the IRS and stating, "Permitting taxpayers to unwind in this circumstance would allow them to contest the initial denial of favorable treatment by the government and, if unsuccessful, to obtain a second-best result through the unwind. In effect, the availability of unwind treatment makes the tax liability on an alternative, less aggressive transaction the exercise price of a put option on taking a more aggressive position.").

182. *Id.*

183. *See supra* Part I.B.3.

2. Promoting Fairness

Applying the actual transaction doctrine in the overly aggressive pre-transactional tax-planning situation promotes fairness by discouraging overly aggressive pre-transactional tax planning. Taxpayers who engage in overly aggressive pre-transactional tax planning without being audited will pay less tax than other, similarly situated taxpayers. This potential for some taxpayers to benefit is particularly troubling from the perspective of fairness, given that sophisticated taxpayers are more likely to engage in pre-transactional tax planning than unsophisticated taxpayers.[184] Consequently, deterring overly aggressive tax planning may promote fairness, and such tax planning can be deterred by applying the actual transaction doctrine in the overly aggressive pre-transactional tax-planning situation.[185]

3. Fostering Efficiency

The application of the actual transaction doctrine to the overly aggressive pre-transactional tax-planning situation has uncertain effects on efficiency. The application of the actual transaction doctrine deters taxpayers from selecting Form Three and encourages taxpayers to select Form One instead.[186] Thus, if Form One generates a higher pre-tax return than Form Three, the actual transaction doctrine promotes efficiency. However, if Form Three generates a higher pre-tax return than Form One, the actual transaction doctrine undermines efficiency.

IV. PROPOSED CHANGES TO THE LAW

The actual transaction doctrine applied to the inadequate pre-transactional tax-planning situation may prevent some tax revenue erosion, but it does so at the expense of undermining fairness by favoring sophisticated taxpayers.[187] In addition, applying the doctrine in this situation has minimal effects on the goal of fostering efficiency but, if anything, may undermine this goal.[188] Consequently, the actual transaction doctrine should no longer apply in the inadequate pre-transactional tax-planning situation, provided that certain requirements are met.

A. Proposal in Detail

The actual transaction doctrine should no longer apply in the inadequate pre-transactional tax planning situation, provided that the following three requirements are met. First, the taxpayer must convincingly establish that he or she selected a given transactional form over an alternative form because of

184. *See supra* notes 132–34 and accompanying text.
185. *See supra* Part III.C.1.
186. *See supra* Part III.C.1.
187. *See supra* Parts III.B.1–2.
188. *See supra* Parts III.B.3.

inadequate pre-transactional tax planning.[189] The taxpayer must show that he or she did not choose a given transactional form because he or she expected the transaction to generate different economic consequences.

Second, a taxpayer may report the tax consequences that follow from an alternative transactional form only if the taxpayer has not already filed tax returns reporting the results from the transactional form actually used. Limiting reform in this way addresses administrative concerns that would arise if tax returns had already been filed, and would have to be amended and potentially re-audited.

Third, a taxpayer may report the tax consequences that follow from an alternative transactional form only if all taxpayers involved in the transaction agree to report the tax consequences based upon the same alternative form. This prevents potential whipsaw of the IRS that could otherwise occur.[190] In particular, unless all parties involved in a transaction agree to report tax consequences based on the same alternative transactional form, the parties could report inconsistent tax consequences. For example, assume one taxpayer (Acquiring Party) is acquiring property from another taxpayer (Disposing Party). If the taxpayers are not required to report results based on the same transactional form, the Acquiring Party could report tax consequences following from the transactional form actually used if it results in the Acquiring Party obtaining a higher tax basis in the property. At the same time, the Disposing Party could report tax consequences following from an alternative transactional form that results in the Disposing Party recognizing a lesser amount of tax gain with respect to the property. If this inconsistency was allowed, the taxpayers would whipsaw the IRS because the Acquiring Party would obtain a higher tax basis without the Disposing Party paying the cost required to obtain that higher basis, namely, the recognition of tax gain. This potential whipsaw is avoided if all parties agree to report tax consequences based on a given alternative transactional form.

189. Inadequate pre-transactional tax planning includes a lack of planning before undertaking a transaction. It could also encompass a situation in which a taxpayer uses a transactional form that leads to higher tax liability than an alternative form as a result of receiving faulty advice ahead of time. In the latter case, it might be argued that no change to the actual transaction doctrine is necessary because the taxpayer can obtain a remedy by bringing a malpractice claim against the advisor who provided faulty counsel. For further discussion of this possibility, see *supra* note 132. Although this argument has merit, there is also merit to allowing such a taxpayer to report the tax results of the alternative form. If the advisor who provided faulty counsel discovers the error, the advisor will be more likely to alert the taxpayer to this information if the taxpayer is able to correct the error by reporting the results of the alternative transactional form. If bringing a malpractice claim is the taxpayer's only remedy, the taxpayer may be less likely to discover that the initial advice was flawed.

190. For discussion of the whipsaw concern, see *supra* note 32.

B. An Alternative: Rationalizing the Law

In lieu of the reforms proposed above, modifications to tax law could focus on eliminating situations in which similar transactions receive different tax treatment. If the law were "rationalized," which is to say if multiple forms of a transaction that are equally true to the same underlying substance received the same tax treatment, the actual transaction doctrine would no longer be necessary.[191] Moreover, rationalizing the law could better mitigate many of the harms arising from pre-transactional tax planning, including tax revenue erosion, unfairness, and inefficiency.

Regarding tax revenue erosion, more tax revenue could be collected if tax law were rationalized. Even under the currently applied actual transaction doctrine, taxpayers can exploit available pre-transactional tax-planning opportunities resulting from the fact that different transactional forms receive different tax treatment.[192] If the law was rationalized, the Treasury would lose less revenue as a result of pre-transactional tax planning.

Rationalizing the law could also serve the goal of promoting fairness. If the law was rationalized, regardless of the transactional form used, a taxpayer would achieve the same tax consequences. Thus, in many cases, tax

---

191. In the example described in Part II.B.2, the law was later rationalized such that both the form used and the alternative form lead to the same tax consequences. In particular, after the repeal of the "General Utilities" doctrine, the transaction used and the alternative transaction lead to the same tax consequences. Under current law, the tax treatment of the transaction used and the alternative transaction are as follows: as a result of the transaction used, when Subsidiary redeems half of the stock in Subsidiary held by Parent in exchange for a check and a note (worth $100), Parent will recognize a gain from sale of the Subsidiary stock equal to the excess of the value of the check and note ($100) over Parent's basis in the Subsidiary stock ($40), or $60 of gain. I.R.C. §§ 302(a), 302(b)(3) (2006). When Parent transfers the note and check to Exiting Shareholder in redemption of the Parent stock held by Exiting Shareholder, Exiting Shareholder will recognize a gain from the sale of the Parent stock equal to the excess of the value of the check and note ($100) over Exiting Shareholder's basis in the Parent stock ($30), or $70 of gain. §§ 302(a), 302(b)(3). The same tax consequences result from the alternative form of the transaction. Under this form, when Parent distributes half of the Subsidiary stock that it holds to Exiting Shareholder in redemption of Exiting Shareholder's interest in Parent, Parent will recognize a gain from a deemed sale of the Subsidiary stock equal to the excess of the value of the Subsidiary stock ($100) over Parent's basis in the Subsidiary stock ($40), or $60 of gain. § 311(b). Exiting Shareholder's basis in the Subsidiary stock received will equal fair market value ($100). Additionally, upon receipt of the Subsidiary stock, Exiting Shareholder will recognize a gain from the sale of the Parent stock equal to the excess of the value of the Subsidiary stock ($100) over Exiting Shareholder's basis in the Parent stock ($30), or $70 of gain. §§ 302(a), 302(b)(3). When the check and note are distributed from Subsidiary to Exiting Shareholder in redemption of the Subsidiary stock, no further gain or loss will be recognized by Exiting Shareholder or Subsidiary, because (i) Subsidiary's basis in the check and note, (ii) Exiting Shareholder's basis in the Subsidiary stock, and (iii) the fair market value of the check and note each equal $100. Thus, regardless of the form of the transaction, Parent recognizes $60 of gain from the sale of Subsidiary stock, and Exiting Shareholder recognizes $70 of gain from the sale of Parent stock.

192. *See supra* Part I.B for examples.

consequences would be less dependent on whether a taxpayer received adequate tax advice before engaging in a transaction. In other words, rationalizing the tax law makes it more substance-driven and less dependent on form, and substance-based tax consequences would be more consistent with the expectations of unsophisticated taxpayers.[193] Thus, taxpayers that failed to seek advice before engaging in a transaction would be less disadvantaged because tax consequences would be more consistent with their uninformed expectations.

Regarding inefficiency, if the law was rationalized, by definition, equivalent forms of a given transaction would lead to the same effective tax rate. As a result, a taxpayer would select among the forms based on non-tax factors such as the forms' pre-tax returns. These results may be positive from the perspective of fostering efficiency. Alternatively, it is also possible that eliminating one opportunity for tax planning, namely, the opportunity to select among differently-taxed, equivalent transactional forms, could cause a taxpayer to engage in other, even more wasteful types of tax planning. Thus, in some cases, rationalizing the law could breed inefficiency by encouraging taxpayers to refocus their pre-transactional tax planning on more wasteful strategies.[194]

Although rationalizing the law may, in many cases, be a preferable solution for the reasons previously described, rationalizing the law will not always be politically feasible or desirable.[195] For this reason, differing tax treatment of similar transactional forms will persist, the actual transaction doctrine will have enduring relevance, and the proposed reforms to the doctrine will continue to have merit.

---

193. *See supra* note 10 and accompanying text.

194. *See supra* note 137 (discussing this phenomenon in connection with limiting tax planning opportunities generally).

195. For example, in the case in which the form involves making (or not making) a tax election so that a business is treated as a partnership and the alternative form involves making (or not making) a tax election so as to conduct the same business as a corporation, rationalizing the law would entail equalizing the tax treatment of partnerships and corporations. Such reform is likely politically unfeasible. Legal scholars, economists, and other commentators have long advocated for reform of the corporate tax system in order to integrate the entity-level tax and the tax that applies to shareholders upon receipt of dividends to make the tax treatment of corporations more similar to partnerships. Despite abundant calls for corporate tax integration, the corporate tax system continues as distinct from the partnership tax system. A discussion of the arguments supporting corporate tax integration is beyond the scope of this Article. For some discussion of corporate tax integration, see generally Joseph M. Dodge, *A Combined Mark-to-Market and Pass-Through Corporate-Shareholder Integration Proposal*, 50 TAX L. REV. 265 (1995); R. Glenn. Hubbard, *Corporate Tax Integration: A View From the Treasury Department*, 7 J. ECON. PERSPECTIVES 115 (1993); Charles E. McLure, *Integration of the Personal and Corporate Income Taxes: The Missing Element in Recent Tax Reform Proposals*, 88 HARV. L. REV. 532 (1975); and Alvin Warren, *The Relation and Integration of Individual and Corporate Income Taxes*, 94 HARV. L. REV. 719 (1981).

C. Potential Criticisms

The proposed reforms may elicit a number of criticisms that fall in one of two categories. The first category includes concerns that the reforms do not accomplish enough, and the second category consists of claims that the reforms go too far.

1. The Reforms Do Not Accomplish Enough

First, one concern might be that taxpayers will not discover their mistake in time to claim the tax consequences that would follow from an alternative transactional form. For the same reasons that unsophisticated taxpayers do not seek pre-transactional tax advice alerting them to the benefits of using an alternative form, they may not learn of these benefits after the transaction occurs. Although this concern has merit, the reforms, nevertheless, represent an improvement upon current law in that the reforms will assist some additional unsophisticated taxpayers. In particular, even when unsophisticated taxpayers do not seek tax advice ahead of time, in some cases they will seek advice at the tax return preparation stage because they will be aware of the need to report tax consequences after a transaction occurs.[196] At this stage, advisors could alert them to the tax consequences that would have followed from an alternative form. Moreover, because this will occur at the return preparation stage, mistakes will be uncovered in some cases before any tax returns are filed and, thus, at a time when the mistakes can still be corrected under the proposed reforms.[197]

A second concern may be that reforms will have little practical effect given the requirement that all affected taxpayers must agree to report tax consequences based on the same alternative transactional form. It is true that, often, the parties to a transaction will have opposing interests.[198] In connection with a given transaction, one party may obtain better tax consequences by reporting the results of the form actually used, while the other party might obtain better tax consequences by reporting the results of an alternative form.[199] In such a transaction, the first party is unlikely to agree to report the consequences of the alternative form unless the second party compensates the first party for doing so.[200] However, in addition to the possibility that the party who benefits from the alternative reporting could compensate the party who is

196. *See supra* notes 132–34 and accompanying text.

197. *See supra* note 134 and accompanying text.

198. In the example in Part IV.A, for instance, the Acquiring Party and the Disposing Party have opposing interests.

199. In the example in Part IV.A, for instance, the Acquiring Party and the Disposing Party have opposing interests.

200. In the example in Part IV.A, the Acquiring Party could pay a greater purchase price to the Disposing Party in exchange for the Disposing Party's agreement to report tax consequences based on a form that results in the Acquiring Party obtaining a higher tax basis and the Disposing Party recognizing more tax gain.

harmed, there are also many transactions in which the interests of the parties are aligned, as demonstrated by the following example. In the transaction described in Part I.B.1 and shown in Figures 1 and 2, if the assets both have built-in gains, Form One would lead to tax consequences that are better, or at least as good, for all involved parties than the tax consequences that would follow from Form Two. If the parties failed to receive adequate advice and used Form Two, the parties conceivably could later agree to report the consequences that would have followed from Form One.

A final concern may be that continued restrictions on post-transactional tax decisions, such as restrictions on the ability to unwind a transaction for tax purposes, would dampen the ability of the proposed reforms to promote fairness because these restrictions would continue to disproportionately harm unsophisticated taxpayers. Although this concern has merit in that some aspects of unfairness would persist, the proposed reforms have the virtue of addressing many of the most blatant causes of unfairness. The proposed reforms apply in cases where, if the taxpayer had received any adequate pre-transactional advice, he or she almost certainly would have structured a transaction differently. In order to demonstrate this point, one must recall that the reforms would apply when an alternative transactional form was available and both that form and the form actually used were equally true to the same underlying substance. In other words, the reforms apply when the non-tax differences between the form used and the alternative form are minimal or non-existent. Given the lack of significant non-tax differences, the choice of the alternative form would have been easy and automatic if the taxpayer had been informed about its tax benefits. Thus, the reforms address cases in which taxpayers who do not receive pre-transactional tax advice are deprived of opportunities available to informed taxpayers to obtain significant tax benefits without incurring substantial non-tax costs.

2. The Reforms Go Too Far

First, one may object to the reforms on the grounds that they will discourage planning before a transaction, which could have negative non-tax implications. For some taxpayers, pre-transactional tax planning might provide collateral benefits because a taxpayer may discover non-tax issues warranting consideration. For example, the sense that tax-planning opportunities exist may prompt an individual to consult a lawyer about estate planning considerations, which could lead to resolution of non-tax issues.

In response to this concern, one can observe that, even with the proposed changes to the actual transaction doctrine, post-transactional tax decisions would not always be available to taxpayers who fail to engage in pre-transactional tax planning because the actual transaction doctrine is not the only obstacle to post-transactional tax decisions.[201] In particular, as previously

---

201. *See supra* Part I.C.

discussed, the actual transaction doctrine applies only when the form used and the alternative form are equally true to the same underlying substance.[202] In some cases, the transaction undertaken will not have the same substance as the alternative transaction because many non-tax differences will distinguish the two transactions.[203] In such a case, a taxpayer would be entitled to claim the tax consequences of the alternative transaction only if he or she reversed the non-tax effects of the actual transaction and subsequently carried out the alternative transaction.[204] Limitations on a taxpayer's ability to unwind a transaction for tax purposes will hinder the taxpayer's ability to do so. Thus, post-transactional tax decisions will continue to be unavailable in some cases that involve inadequate pre-transactional tax planning. Because of the continued limitations on post-transactional tax decisions, the proposed reforms would not likely cause taxpayers to cease engaging in pre-transactional tax planning. Thus, taxpayers who currently tax plan would not lose the collateral benefits of tax planning.

A second concern might be that an inadequate pre-transactional tax-planning situation could be difficult to distinguish from an unexpected economic outcome situation. Thus, it might not be possible to allow post-transactional tax-planning decisions in the former situation without also, inadvertently, allowing such decisions in the latter.

To address this concern, a burden could be placed on taxpayers to convincingly establish that their choice of a transactional form resulted from a lack of adequate pre-transactional tax planning. For example, a taxpayer may show that he or she did not receive tax advice before the transaction. Alternatively, if he or she did receive tax advice, the taxpayer could demonstrate that the advice was based upon economic projections that turned out to be accurate. If the taxpayer can show that the economic outcome of the transaction was expected, it would be natural to infer that the taxpayer failed to choose the alternative form because of misinformation about tax law or, stated differently, because of inadequate pre-transactional tax planning. Again, it helps to bear in mind that the actual transaction doctrine applies when the form used does not differ from the alternative form in any significant non-tax respects. Because the forms achieve the same non-tax objectives, if the taxpayer's economic predictions are correct and the taxpayer is properly informed about tax law, the taxpayer has no reason to do anything other than pick the form that leads to favorable tax consequences. Hence, if a taxpayer's economic predictions are correct and the taxpayer fails to pick the form that leads to favorable tax consequences, it is natural to infer that the taxpayer was not properly informed about tax law.

202. *See supra* Part I.C.
203. *See supra* Part I.C.2.
204. *See supra* Part I.C.2.

V. CONCLUSION

Tax law disallows post-transactional tax decisions in a variety of ways. One example is the actual transaction doctrine. Restrictions on post-transactional tax decisions may be designed to serve a number of underlying policy goals. Such goals include: preventing tax revenue erosion, promoting fairness, and fostering efficiency. In many cases, these goals would be best served by reforming the law so that similar forms of a given transaction lead to the same tax consequences. However, because rationalizing the law in this manner will not always be feasible, alternative reforms should be explored. One such alternative reform involves revising the actual transaction doctrine to more readily allow post-transactional tax decisions when taxpayers fail to engage in adequate pre-transactional tax planning.