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Relational Tax Planning Under Risk-Based Rules

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RELATIONAL TAX PLANNING UNDER RISK-BASED RULES

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Risk-based rules are the tax system's primary response to aggressive tax planning. They usually grant benefits only to those taxpayers who accept risk of changes in market prices (market risk) *or business opportunities* (business risk). *Attempts to circumvent these rules by hedging, contractual safeguards, and diversification are well understood. The same cannot be said about a very different type of tax planning. Instead of reducing risk directly, some taxpayers change the nature of risk. They enter into informal, legally unenforceable agreements with contractual counterparties that are designed to eliminate market or business risk entirely. The new uncertainty these tax planners inevitably accept, however, is the risk that the counterparties will violate the implicit agreements and betray taxpayers' trust* (counterparty risk). *A deliberate substitution of counterparty risk for market or business risk is what this Article calls* relational tax planning. *The Article offers an economic analysis of different risks and considers two responses to the relational tax planning problem. The analysis suggests that from a welfarist perspective, business risk is a superior deterrent compared to both market and counterparty risks. Counterparty risk is the most complex of the three. In addition to producing risk-bearing losses like all other risks, it leads to reduced transaction costs in future exchanges between relational tax planners, but only if they manage to overcome bargaining obstacles caused by opportunism and asymmetric information. These insights suggest two very different responses. A sweeping reform will allow—and even encourage—taxpayers to engage in relational tax planning, but it will also ensure that counterparty risk they incur is sufficiently high. If only incremental improvements are pursued, courts should increase their scrutiny of relational tax planning involving extensive dyadic business relationships and interactions based on social norms.*

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INTRODUCTION

Contrary to popular belief, death and taxes have little in common. While death is indeed certain, taxpayers have plenty of ways to escape (some of) their tax obligations. But they must pay a price: work less than they would have liked, save less than they would have preferred, or do a number of other things they would rather not do. This Article is about one unpleasant consequence that taxpayers must often accept as a price of lowering their tax bills—risk.

Tax law is full of risk-based rules—provisions that grant tax benefits only to those who accept a certain amount of risk.[1] Yet courts and scholars have failed to recognize that not all risks are the same. As a result, the government's efforts to protect the tax base by relying on risk-based rules have been even less successful than is commonly acknowledged.

The multitude of risk-based rules that pervade all areas of tax law are deceptively similar. They all appear to bestow benefits only on those who accept risk of changes in market prices (*market risk*) or business opportunities (*business risk*). Because many taxpayers dislike risk, random market forces deter them from engaging in undesirable tax planning—or so the government hopes. Virtually all commentary regarding risk-based rules has focused on market risk.[2]

Yet taxpayers often face a very different kind of uncertainty. They attempt to reduce their taxes by relying on assistance from contractual partners without obtaining a legally enforceable right to compel these partners to act as the parties agreed. These tax planners assume the risk that their counterparties will not perform as promised (*counterparty risk*). Factors affecting this type of uncertainty—such as asymmetric information and opportunistic behavior—are fundamentally different from those that underlie market and business risks.

Taxpayers' efforts to engage in what I call *traditional tax planning*—reducing market and business risks by hedging, contractual safeguards, and diversification—have drawn plenty of interest from policymakers and academics alike. At the same time, taxpayers have learned to substitute counterparty risk for market and business risks and engage in what I refer to as *relational tax planning* without too much unwanted attention. The disparity is understandable. Traditional tax planning is often easy to define and detect because it involves reliance

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[1] Daniel Shaviro defined risk-based rules as "rules that give the presence or absence of elements of economic risk a tax significance that is distinct from any effect that such risk has on fair market value or the accrual of economic gain or loss." Daniel Shaviro, *Risk-Based Rules and the Taxation of Capital Income*, 50 TAX L. REV. 643, 643 (1995) [hereinafter Shaviro, *Risk-Based Rules*].

[2] *See, e.g.*, Robert H. Scarborough, *Risk, Diversification and the Design of Loss Limitations Under a Realization-Based Income Tax*, 48 TAX L. REV. 677, 679-81 (1993); Deborah H. Schenk, *Taxation of Equity Derivatives: A Partial Integration Proposal*, 50 TAX L. REV. 571, 583-87 (1995); Shaviro, *Risk-Based Rules*, *supra* note 1, at 645-50; Alvin C. Warren, Jr., Commentary, *Financial Contract Innovation and Income Tax Policy*, 107 HARV. L. REV. 460, 460-61 (1993).

on express, written contracts. These contracts may be long, complex, and seemingly unrelated to transactions that give rise to the underlying risk, but often they are clear, readily observable, and verifiable. In contrast, relational tax planning is much harder for the government to counter. It depends on tacit understandings and implicit agreements that are difficult to define, identify, and prove in court.

For example, a risk-based wash sale rule attempts to foreclose tax-motivated loss harvesting by denying a deduction to taxpayers who sell securities at a loss and repurchase identical securities within thirty days.[3] Tax planners may try to circumvent this rule by selling the security and immediately buying a thirty-one-day option to purchase an identical security for the same price.[4] Discovering this option is not particularly challenging for the government, nor is deciding whether the waiting period should be suspended if such option is acquired.[5] But what if instead of buying an option, the taxpayer sells the security to a friend or a business associate, with an understanding (unwritten and unenforceable) that the taxpayer will repurchase the security for the same price in just over a month? Administering a system that takes informal arrangements like this into account is much more difficult. It is hardly surprising that the government has not had much success in combating relational planning. Commentators have done little to assist policymakers in developing alternative approaches.[6]

This Article reverses the trend. It highlights the challenge of relational tax planning, offers an economic analysis of market, business, and counterparty risks, and evaluates two alternative reforms. The three risks differ in their deterrent effects and social welfare consequences. Business risk is a particularly attractive policy instrument. Tax planners who accept it not only incur a risk-bearing loss (a private and social cost similar for all risks), but also sustain an expected loss from resolution of future business contingencies (a private cost that has no effect on the overall social welfare). The latter feature makes business risk a more efficient deterrent than market risk.

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[3] The wash sale rule, as well as all other rules and judicial doctrines mentioned in this Article, is more complicated than the discussion suggests. For a detailed analysis of the intricacies of the wash sale provision, see, for example, David M. Schizer, *Scrubbing the Wash Sale Rules*, TAXES, Mar. 2004, at 67 [hereinafter Schizer, *Wash Sale Rules*].

[4] In fact, many did.

[5] It is. I.R.C. § 1091(a) (2000).

[6] For an effort to offer one such approach to a particular type of relational tax planning, see Alex Raskolnikov, *The Cost of Norms: Tax Effects of Tacit Understandings*, 74 U. CHI. L. REV. 601, 665-77 (2007) [hereinafter Raskolnikov, *The Cost of Norms*].

The two unique characteristics of counterparty risk are the *cooperation gain* and the *bargaining cost*. The cooperation gain exists because, by relying on contractual partners, taxpayers and their counterparties build (or reinforce) mutual trust. Stronger trust reduces transaction costs, not just in the tax-motivated exchange that produced it, but in all other interactions between the two transactors as well. This is clearly beneficial to relational tax planners. Whether society benefits as well is a much more difficult question. The bargaining cost arises because relational tax planning requires cooperation. Contract scholars and organizational theorists learned long ago that whenever bargaining is required, people occasionally fail to capture available gains from trade.[7] Opportunistic behavior and asymmetric information get in the way. While bargaining failures of commercial actors generally reduce social welfare (valuable goods and services are underproduced), no such reduction occurs when contracting is tax motivated (fewer tax shelters go forward). Therefore, the bargaining cost acts as an additional deterrent without increasing the social cost of counterparty risk.

These insights allow us to evaluate two responses to the relational tax planning problem: a sweeping reform and a set of incremental improvements. The former alternative is a complete reversal of the current approach. Rather than designing risk-based rules with market risk in mind and then struggling to protect them from taxpayers' attempts to switch to counterparty risk, the government may deliberately allow taxpayers to make the substitution. The key point is that this concession will produce no windfall to relational tax planners as long as the amount of risk they must incur to obtain the desired tax benefits is sufficiently high, assuming the market-risk-to-counterparty-risk conversion. Continuing with the wash sale example, if a thirty-day waiting period is too short, assuming the wash seller has an informal arrangement to repurchase the security, a longer waiting period may restore the balance. Whether it will take two months, three months, or even longer, at some point the private cost of a possible counterparty defection may become roughly as great as the private cost of incurring market risk produced by the current thirty-day waiting period.

This approach has two clear advantages. First, once the extended waiting period is chosen, the government no longer needs to continue its (largely unsuccessful) efforts to weed out tacit understandings. Enforcement costs are significantly reduced. Second, more taxpayers

[7] *See, e.g.*, sources cited *infra* notes 74-75.

start to cooperate with each other. This increases both the cooperation gain and the bargaining cost. Because the latter is a direct cost present in any negotiation while the former is a second-order future benefit available only to some relational tax planners, the net result is likely to be a larger (private, but not social) cost. If so, counterparty risk becomes a more attractive policy instrument than market risk, just like business risk is today. Yet the alternative regime comes with considerable drawbacks. It imposes new losses on taxpayers who engage in no tax planning at all. It overdeters uncooperative tax planners. Taxpayers will surely try to circumvent the new regime, and it is uncertain how much success they are likely to have.

Incremental improvements to the existing risk-based rules are a less ambitious solution. In sum, the current judicial doctrines that function as risk-based rules are insufficiently nuanced. Business risk of the same magnitude as a given market risk is a stronger deterrent, so courts should be relatively more lenient in business risk cases. Counterparty risk is most costly for business transactors engaged in single-shot deals. Extensive commercial relationships reduce losses from incurring this risk. And environments where parties interact based on mutually shared informal understandings commonly referred to as social norms are even more conducive to relational tax planning. Courts should take these differences into account and scrutinize transactions in the last two categories even more than they do today.

Part I briefly explains the importance of improving risk-based rules. Part II distinguishes between market, business, and counterparty risks. Part III defines and discusses relational tax planning, arguing that it renders risk-based rules particularly ineffective. Part IV evaluates the deterrent effects and social welfare implications of various risks. Part V considers a dramatic reform—and Part VI suggests a set of incremental improvements—that present policymakers with very different solutions to the problem of relational tax planning under risk-based rules.

I. WHY BOTHER WITH IMPROVING RISK-BASED RULES?

Before delving into a detailed analysis of risk-based rules, one must address an immediate objection: these rules do not work; why bother with improving them?

Take the wash sale rule as an example. It disallows a deduction from selling a security at a loss (the *loss security*) unless the seller waits for thirty days before repurchasing an identical one. What is the point of forcing taxpayers to wait? The real problem is tax-motivated sales, whether or not followed by repurchases. These sales are inefficient because the selling taxpayers change their behavior solely to improve their tax positions. They are worse off, and no revenue is collected. The standard deadweight loss of tax planning is the result.[8] However, discerning and proving taxpayers' intent or motive is costly. A bright-line rule imposing a waiting period is much easier to administer. And its effect, it is hoped, will often be the same as that of a cumbersome intent-based inquiry. Tax-motivated sales will diminish because tax planners will be reluctant to accept a risk that the loss security will appreciate during the waiting period and they will have to pay more to repurchase it than they received from its sale. At the same time, "real" (not tax-motivated) transactions will continue unaffected because taxpayers who want to get rid of the loss security for good will care little about its possible appreciation during the next thirty days. What a nice solution! No wonder the tax law is full of risk-based rules.

Yet these rules have been subjected to a devastating—and justifiable—criticism.[9] Forcing taxpayers to bear risk has no connection to income measurement or any other fundamental goal of our tax system. It is just a friction—a cost imposed on taxpayers to prevent them from escaping tax, primarily on capital income.[10] And as far as frictions go, risk is not a particularly effective one.[11] It typically functions as a weak, continuous friction that can be avoided by a minor adjustment in behavior.[12] Imposing this type of friction does little to reduce elasticity of taxable income and, therefore, is likely to be rather inefficient.[13] Daniel Shaviro drove the point home by arguing (only half-

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[8] *See, e.g.*, HARVEY S. ROSEN, PUBLIC FINANCE 283-305 (7th ed. 2005).

[9] *See* Shaviro, *Risk-Based Rules, supra* note 1; Lewis R. Steinberg, *Commentary*, 50 TAX L. REV. 725 (1995).

[10] Frictions are "transaction costs incurred in the marketplace that make implementation of certain tax-planning strategies costly." MYRON S. SCHOLES ET AL., TAXES AND BUSINESS STRATEGY: A PLANNING APPROACH 9 (3d ed. 2005). The view of risk-based rules as pure frictions is not uniformly accepted. *See, e.g.*, David M. Schizer, *Frictions as a Constraint on Tax Planning*, 101 COLUM. L. REV. 1312, 1360 (2001) [hereinafter Schizer, *Frictions*].

[11] *See* Schizer, *Frictions*, *supra* note 10, at 1325-26.

[12] *Id.*

[13] *See* David A. Weisbach, *An Economic Analysis of Anti-Tax-Avoidance Doctrines*, 4 AM. L. & ECON. REV. 88, 99-103 (2002) (arguing that the sham transaction doctrine is a weak deterrent because it fails to stop numerous shelters and, therefore, has little effect on taxable income elasticity). Admittedly, not all risk-based rules give rise to continuous frictions. Yet, as David Schizer explains, the government often stumbles into

jokingly) that if forcing taxpayers to do twenty back-somersaults on April Fool's Day would allow the government to collect the necessary revenue while creating fewer distortions and imposing smaller costs than the current system does, we should go with the somersaults.[14]

To make things worse, the government cannot assume that risk-based rules actually result in the imposition of a meaningful risk. That these rules fail to deter most tax planning involving financial assets is hardly a matter for debate.[15] Provisions that apply to tangible assets are also suspect.[16] Even more disheartening is the near consensus that little, if anything, can be done to improve risk-based rules or devise alternative approaches that would assure adequate taxation of capital income.[17] And if things are that bad, why bother with taxing capital income at all? Why not just switch to a consumption tax and leave the nightmare of risk-based rules far behind?[18]

Several reasons come to mind. First, a consumption tax, it turns out, is no panacea. As soon as David Weisbach subjected the Flat

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effective discontinuous frictions simply by accident. *See* Schizer, *Frictions*, *supra* note 10, at 1371-74.

[14] Daniel N. Shaviro, *Economic Substance, Corporate Tax Shelters, and the* Compaq *Case*, 88 TAX NOTES 221, 223 (2000) [hereinafter Shaviro, *Tax Shelters*].

[15] Traditional tax law's distinctions between ownership and use, debt and equity, and fixed and contingent returns have proved to be no match to those who have conquered the power of the put-call parity theorem. *See* Warren, *supra* note 2, at 465-67; *see also* Edward D. Kleinbard, *Equity Derivative Products: Financial Innovation's Newest Challenge to the Tax System*, 69 TEX. L. REV. 1319, 1327-30 (1991); Schenk, *supra* note 2, at 574-79; Shaviro, *Risk-Based Rules*, *supra* note 1, at 651-56; Jeff Strnad, *Taxing New Financial Products: A Conceptual Framework*, 46 STAN. L. REV. 569, 569-74 (1994); Warren, *supra* note 2, at 482-91; David A. Weisbach, *Tax Responses to Financial Contract Innovation*, 50 TAX L. REV. 491, 496-507 (1995). *But see* Mark P. Gergen, Afterword, *Apocalypse Not?*, 50 TAX L. REV. 833 (1995).

[16] At least in one commentator's view, they produce nonoptimal risk allocations, misdirect resources, and generally amount to not much more than a "tax planning nuisance." Shaviro, *Risk-Based Rules*, *supra* note 1, at 695.

[17] *See id.* at 723-24; Strnad, *supra* note 15, at 604-05. In the words of one observer, Congress's repeated attempts to "'solve' the problem of financial asset taxation . . . has done little to stop the proliferation of tax-motivated financial transactions, while subjecting (at least part of) the tax law to mind-numbing complexity." Steinberg, *supra* note 9, at 729; *see also* Joseph Bankman, Commentary, 50 TAX L. REV. 787, 787 (1995) ("The income tax treatment of capital is a mess.").

[18] *See* Bankman, *supra* note 17, at 792 (concluding that while David Bradford's proposed reform of income tax is an improvement over the current system based on risk-based rules, it is still less efficient than a consumption tax); Shaviro, *Risk-Based Rules*, *supra* note 1, at 723-24 ("[T]he increasing difficulty of reaching capital under an income tax, by reason of the declining effectiveness of deterring tax planning through risk-based rules, strengthens the case for shifting to consumption taxation."); Steinberg, *supra* note 9, at 729 & n.20.

Tax—a specific (and relatively politically viable) consumption tax proposal—to moderate scrutiny, he found that it is vulnerable to the same tensions that gave rise to the existing risk-based rules.[19] To be sure, some of the Flat Tax weaknesses are due to its unique features, and some arise because of transition issues.[20] But several difficult line-drawing problems plaguing today's income tax remain important in any consumption tax regime.[21] While risk-based rules may well be less central in some such regimes than they are in an income tax system, a switch to a consumption tax will not free us from the need to rely on these rules.

Nor is a wholesale switch to a consumption tax likely. While the Flat Tax and other consumption tax proposals continue to be discussed by academics and politicians,[22] there appears to be no real ef-

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[19] *See* David A. Weisbach, *Ironing Out the Flat Tax*, 52 STAN. L. REV. 599, 616 (2000) [hereinafter Weisbach, *Flat Tax*]. The troubling distinctions between owners and non-owners, debt and equity holders, and time-value and risky returns remain important. *See id.* at 615, 628-29, 635. Even the transactional patterns are eerily familiar: a sale and repurchase, *see id.* at 615, 628-29, 660-61, a sale and leaseback, *see id.* at 628 n.41, 660-61, a straddle, *see id.* at 616, and, more generally, an arbitrage based on different tax treatment of similar cash flows, *see id.* at 625, 628-29. In what must come as a shock to those who hoped that a switch to a consumption tax would end the struggles with taxation of financial instruments once and for all, Weisbach concludes that "[t]he financial products rules under an income tax probably have greater potential to be coherent than those under the Flat Tax." *Id.* at 663. By referring to Professor Weisbach's scrutiny as "moderate," I in no way mean to undermine the rigor of his analysis or the value of his contribution, both of which are high. Rather, as Weisbach himself pointed out, his incentives to find loopholes in the Flat Tax were not nearly as strong as those incentives would be when the brightest minds of the American tax bar set out on a search for weaknesses in the new regime with hundreds of millions of dollars on the line. *Id.* at 629.

[20] *See id.* at 660-61. For instance, tax planning using forward straddles is possible because the Flat Tax is open and ignores financial transactions. *Id.* at 616. Similarly, mischaracterization of interest is much less of a concern in closed regimes like the European VATs. *Id.* at 629. Professor Shaviro anticipated these types of difficulties and advocated a consumption tax that makes "the form of one's asset transactions as irrelevant as possible—a consideration that may prove in some tension with transitional relief or proposals that use a graduated rate structure." Shaviro, *Risk-Based Rules*, *supra* note 1, at 724.

[21] Ownership is one example. *See* Weisbach, *Flat Tax*, *supra* note 19, at 615 (explaining why personal versus business ownership of assets is important both in a closed cash-flow consumption tax and an open system that, like the Flat Tax, combines a cash-flow tax with a yield-exempt tax). The distinction between financial and other returns is another. *See id.* at 627-28 (noting that tax planning based on overstating the interest component of purchase price is possible in open and closed systems).

[22] For an academic discussion, see, for example, DAVID F. BRADFORD, FUNDAMENTAL ISSUES IN CONSUMPTION TAXATION (1996), proposing the "X-Tax," and David A. Weisbach, *Does the X-Tax Mark the Spot?*, 56 SMU L. REV. 201 (2003), which discusses Bradford's proposal. For continuing political debates, see, for example, Heidi Glenn,

fort to bring about an actual reform. European experience suggests that even if Congress enacts a consumption tax (such as a VAT), the new tax is likely to supplement rather than supplant the existing income tax.[23]

Moreover, a withering scholarly critique of risk-based rules appears to make little impression on courts and policymakers. Congress continues to add these rules to the Internal Revenue Code.[24] The fundamental tax common law doctrines (many of which are risk-based rules) remain in active use.[25] The reason for this continuing reliance is no mystery. While devising and applying risk-based rules surely places informational demands on policymakers and judges, these demands increase manyfold once some more effective frictions are considered.[26] It is hardly surprising that decision makers routinely forgo

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"Cleanse the Code" Reform Effort Attracts Strange Bedfellows, 113 TAX NOTES 949 (2006), describing statements by various politicians and lobbying groups favoring different versions of a consumption tax.

[23] *See* JOEL SLEMROD & JON BAKIJA, TAXING OURSELVES: A CITIZEN'S GUIDE TO THE DEBATE OVER TAXES 15 (3d ed. 2004) ("By 1999, all OECD nations except the United States had adopted VATs, which on average raised 6.4 percent of GDP."). For a similar proposal in the U.S. context, see Michael J. Graetz, *100 Million Unnecessary Returns: A Fresh Start for the U.S. Tax System*, 112 YALE L.J. 261, 281-99 (2002).

[24] *See, e.g.*, I.R.C. § 901(k) (2000) (added in 1997); I.R.C. § 901(*l*) (Supp. IV 2004) (added in 2004); I.R.C. § 1259 (2000) (added in 1997); *id.* § 1260 (added in 1999).

[25] For recent cases relying on the economic substance doctrine, see, for example, *Coltec Industries v. United States*, 454 F.3d 1340 (Fed. Cir. 2006) and *Black & Decker v. United States*, 436 F.3d 431 (4th Cir. 2006). The point that the economic substance doctrine is a risk-based rule is not new. *See* Shaviro, *Tax Shelters*, *supra* note 14, at 222.

[26] Granted, the magnitude of risk produced by a 30-day waiting period is uncertain, and it differs depending on the volatility of the security in question. Similarly, the constructive sale rule that accelerates a taxable gain for taxpayers who eliminate "substantially all" of their economic exposure to an appreciated stock produces considerable ambiguity. Still, policymakers probably have a rough sense of the amount of risk involved. A 30-day waiting period is surely less risky than a 90-day one. *Compare* I.R.C. § 1091(a) (2000) (thirty days), *with id.* § 246(c)(2) (ninety days). A test that triggers unfavorable tax consequences if taxpayers eliminate "substantially all" risk of loss is clearly less demanding than the one that applies even to those who merely "substantially diminish" that risk. *Compare* STAFF OF J. COMM. ON TAXATION, 105TH CONG., GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN 1997, at 177 (Comm. Print 1997) (interpreting § 1259 to include transactions that "have the effect of eliminating *substantially all* of the taxpayer's risk of loss and opportunity for income and gain with respect to the appreciated financial position" (emphasis added)), *with* I.R.C. § 1092(c)(2) (2000) (using the "substantial diminution" standard). Comparisons are rough, but they at least appear to be reasonably plausible based on a general common sense of the drafter of a statute, regulation, or judicial opinion. But if we want to find and develop stronger discontinuous frictions, general common sense will no longer suffice. As David Schizer explained, to identify and evaluate these frictions one would need to be familiar with "a wide range of institutional details, including the securities and commodities laws, the state of financial technology,

reforms that require detailed knowledge of numerous and disparate subjects needed to assess alternative frictions in favor of imperfect but intuitive risk-based rules.[27]

Finally, while risk-based rules have many weaknesses, they are not entirely useless. As Daniel Shaviro acknowledges, the considerable cost of abandoning an ownership-based distinction in the context of safe harbor leasing suggests that the existing risk-based regime had some deterrent effect "at least in the early 1980s."[28] The significant revenue projected from shutting down the modern version of lease-related deduction trading suggests that a risk-based concept of tax ownership continues to play a meaningful role.[29] While a large portion of capital income escapes taxation, hundreds of billions of dollars of interest, dividends, and capital gains are reported and taxed every year.[30] Thus, risk-based rules do raise revenue, although most likely at a high (perhaps too high) cost. Because this revenue is concrete and salient while the accompanying social welfare losses are hidden and debated by economists, policymakers are likely to continue to rely on risk-based rules for some time to come.

Make no mistake, this discussion is no ode to risk-based rules. Their shortcomings are well-known and readily apparent from the government's ongoing struggle to tax capital income. Rather, the point is to emphasize that there are plenty of reasons to search for incremental improvements. The following discussion is animated by this goal.

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accounting, and broker-dealer regulations." Schizer, *Frictions*, *supra* note 10, at 1335. This, no doubt, is only a partial list.

27 Admittedly, even as far as continuous frictions go, risk is a particularly weak one. For instance, the passive loss rules that force taxpayers to sacrifice their time to gain tax benefits appear to be a more effective deterrent. *See* Shaviro, *Risk-Based Rules*, *supra* note 1, at 701.

28 *Id.* at 690.

29 *See, e.g.*, Allen Kenney, *SILO Shutdown: How the New Law Could Cripple the Industry*, 105 TAX NOTES 638, 638 (2004) (reporting that additional revenue from shutting down lease-in, lease-out shelters is projected to be more than $25 billion by 2014, according to congressional budget estimates).

30 For one estimate, see SLEMROD & BAKIJA, *supra* note 23, at 33 tbl.2.3, 34-35 (reporting their estimates for the year 2000 and discussing why a large portion of capital gains escapes taxation). In fact, according to some estimates, net capital gains are the second largest component of the total adjusted gross income, following only wages and salaries. *See, e.g.*, *id.*

II. UNDERSTANDING DIFFERENT TYPES OF RISK

The existing analysis of risk-based rules is extensive but incomplete. The commentary suffers from an insufficiently nuanced understanding of various forms of uncertainty. This Part distinguishes four types of risk, laying the foundation for the discussion in the remainder of the Article.

A. *Market Risk*

The multitude of risk-based rules in the Internal Revenue Code has a certain intellectual tidiness: they all appear to work the same way. All these rules allow taxpayers to claim tax benefits as long as they accept the risk of adverse changes in market prices or asset values. I will call this type of uncertainty *market risk*.[31]

The already familiar wash sale rule is just one example of a market-risk-imposing provision. Similar waiting-period regimes apply to dividends-received deductions,[32] foreign tax credits,[33] and hedges of appreciated securities.[34] These rules are only one type of provision designed to impose market risk. Other examples include the constructive sale rule,[35] the constructive ownership rule,[36] the straddle rules,[37] the conversion transaction provision,[38] certain limitations on

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[31] More precisely, market risk is an unwanted risk of price changes incurred by a passive investor (that is, an owner who has no inside information about the asset's value and cannot influence this value by personal efforts). Thus, market risk arises even if a particular asset is not traded in a liquid (or any) market. However, because most market-risk-imposing provisions do deal with fungible, actively traded assets, I use the term market risk to provide an intuitive reference. My use of this term should not be confused with its use in the corporate finance literature where market (or systematic, or undiversifiable) risk refers to the risk of owning a security that cannot be eliminated by diversification. *See* RICHARD A. BREALEY & STEWART C. MYERS, PRINCIPLES OF CORPORATE FINANCE 168 (7th ed. 2003).

[32] *See* I.R.C. § 246(c)(1)–(2) (2000).

[33] *See* I.R.C. § 901(k), (*l*) (Supp. IV 2004).

[34] *See* I.R.C. § 1259(c)(3) (2000).

[35] *See id.* § 1259(a), (c)(1), (d) (market risk arises because taxpayers are forced to hold appreciated positions that are hedged less than they would have preferred).

[36] *See id.* § 1260(a), (d) (market risk arises because taxpayers are compelled to gain less complete exposure to hedge funds than they would have liked).

[37] *See id.* § 1092(a)(1) (market risk arises because taxpayers cannot substantially diminish unwanted risk of loss without triggering adverse tax consequences).

[38] *See id.* § 1258(c)(1) (market risk arises because taxpayers can avoid a tax-increasing recharacterization only if they embed enough unwanted risk-based (non-time-value) return in their transaction).

interest deductions,[39] some nonrecognition provisions,[40] and the so-called "at risk" limitations.[41] The form and amount of risk forced upon taxpayers vary, as do the tax benefits involved. But invariably, as long as a taxpayer accepts the uncertainty and pays the price by incurring market risk, she is fully entitled to claim the benefits. To facilitate the discussion, I will use the waiting-period provisions (primarily the wash sale rule) as an example of a statutory risk-based rule designed to impose market risk. This should not be interpreted as limiting the analysis or the arguments. Both apply to many different risk-based rules, including those enumerated above.

All the provisions just described are the so-called anti-abuse or one-way rules.[42] They can only increase one's tax burden, never reduce it. They accelerate gains, but not losses;[43] defer losses, but not gains;[44] and recast low-taxed capital gain as high-taxed ordinary income, but not vice versa.[45] Not all risk-based rules are like this. In fact, the more general provisions—such as the rules defining tax ownership, debt, and equity—are typically symmetrical. Symmetrical rules present the government with a unique problem. As soon as it tries to turn them into a "stick crafted to beat on the head of a taxpayer," they invariably "metamorphose . . . into a large green snake and bite the commissioner on the hind part."[46] A reasonable solution is to design

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[39] *See id.* § 163(*l*) (market risk arises because corporate issuers are forced not to price their equity-flavored securities in a way that would assure repayment in equity, as they would have preferred).

[40] *See id.* § 351(g)(2)(A)(iii) (market risk arises because preferred stock whose repayment is too certain carries unfavorable tax consequences).

[41] *See id.* § 465 (market risk arises because taxpayers lose investment-related deductions unless they make investments with their own money or fund investments with recourse (rather than nonrecourse) debt).

[42] *See* Schizer, *Frictions*, *supra* note 10, at 1323 n.29.

[43] *See* I.R.C. § 1259 (2000) (applies only to *appreciated* financial positions); *id.* § 1260 (applies only to *gain* from constructive ownership transactions).

[44] *See id.* §§ 1091, 1092.

[45] *See id.* § 1258.

[46] Martin D. Ginsburg, *Making the Tax Law Through the Judicial Process*, A.B.A. J., Mar. 1984, at 74, 76. For instance, if the government makes it exceedingly easy to characterize corporate securities as debt (and difficult to treat them as equity), corporations will significantly increase their interest deductions by issuing equity-like securities viewed as debt for tax purposes. If the government goes to the opposite extreme (making debt characterization difficult and equity treatment easy), taxpayers will start claiming many more tax benefits associated with dividend payments, such as a dividends-received deduction and foreign tax credit. For a more detailed study of the same dynamic using an example of a risk-based rule applicable to contingent payment debt instruments, see David M. Schizer, *Sticks and Snakes: Derivatives and Curtailing Aggressive Tax Planning*, 73 S. CAL. L. REV. 1339, 1377-92 (2000).

symmetrical rules in a neutral fashion and then deter tax planning with anti-abuse rules. For example, if corporate issuers start claiming interest deductions on novel securities with many equity features, a response would be not to shift the line between debt and equity, but simply to deny interest deduction for this type of security.[47] In other words, the vulnerability of symmetrical rules is *precisely* why anti-abuse rules are important. Not all such rules must be risk based, but many of them are.[48] For the remainder of the Article, I will focus only on anti-abuse (or one-way) risk-based rules.

B. *Business Risk*

A statutory rule that limits the benefits of tax-free incorporations is an example of a provision designed to deter tax planning by imposing business risk. While exchanges are generally taxable,[49] a taxpayer who contributes her appreciated business assets to a corporation in exchange for the corporation's stock is allowed to defer the tax on built-in gain.[50] This favorable treatment is available, however, only if the taxpayer controls that corporation "immediately after the exchange."[51] Courts and the IRS interpreted this requirement to mean that the contributing taxpayer must hold the newly received stock for some time. If the taxpayer plans to continue her business in a corporate form, this requirement hardly matters. But for a taxpayer who would like to engage in a "drop-and-sell" sequence by "dropping" the business assets into a corporation and immediately selling the corporate stock under the guise of a tax-free reorganization, keeping the shares is undesirable. The taxpayer wants to eliminate her exposure to the business as soon as possible. Instead, she must wait and assume

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[47] This is exactly what Congress did when it enacted I.R.C. § 163(*l*). Of course, making the distinction between debt and equity irrelevant (e.g., by repealing the corporate income tax) would solve the problem as well.

[48] The so-called passive loss rules are an example of anti-abuse rules that are not risk based. Rather, they exact the price from taxpayers who wish to claim tax benefits in a coinage of time. *See id.* § 469 (2000); Schizer, *Frictions*, *supra* note 10, at 1324; Shaviro, *Risk-Based Rules*, *supra* note 1, at 701. Note that there is no general correlation between the type of symmetrical rule and the type of related anti-abuse rule. Each rule may be risk based or not. Passive loss rules are an example of non-risk-based anti-abuse rules protecting symmetrical risk-based ownership and debt/equity rules.

[49] *See* I.R.C. § 1001 (2000).

[50] *See id.* § 351(a).

[51] *Id.*

a risk of adverse business developments in order to receive the desired tax treatment. That is, she must accept *business risk*.[52]

Another example of a business-risk-imposing rule comes from the so-called liquidation-reincorporation controversy that embroiled the IRS and numerous taxpayers prior to the 1986 tax reform.[53] As its name suggests, the strategy involved a corporate liquidation followed shortly by an incorporation of a new entity that often bore an uncanny resemblance to the recently liquidated one. Taxpayers could claim a variety of tax benefits if the liquidation and incorporation were viewed as separate transactions.[54] The government argued, however, and courts agreed, that if the incorporation followed the liquidation almost immediately, if the shareholders of the two entities were exactly the same, if the whole transaction was completely prearranged, tax benefits should be disallowed.[55]

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[52] *Compare* W. Coast Mktg. Corp. v. Comm'r, 46 T.C. 32 (1966) (treating the purported sale of stock of a newly incorporated business as a sale of assets because incorporation and sale were too closely linked), *and* Rev. Rul. 70-140, 1970-1 C.B. 73 (same), *with* Culligan Water Conditioning of Tri-Cities, Inc. v. United States, 567 F.2d 867, 870 (9th Cir. 1978) (finding, based on "somewhat murky" facts, that the requirements of § 351 were met where the transfer of assets to the corporation occurred six months prior to the sale of its stock), *and* Weikel v. Comm'r, 51 T.C.M. (CCH) 432 (1986) (refusing to link the steps where assets were "dropped down" more than two months prior to signing of the documents for the sale of stock and four months prior to the sale's closing, distinguishing *West Coast Marketing* and Rev. Rul. 70-140 by highlighting considerable uncertainty of the second-step sale at the time of the first-step incorporation, and relying on *Vest v. Comm'r*, 57 T.C. 128 (1971), *rev'd on other grounds*, 481 F.2d 238 (5th Cir. 1973)). *See generally* 1 BORIS I. BITTKER & JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 3.09[2] (7th ed. 2006). The opposite scenario presented the same issue until Congress intervened in 1954 and, again, in 1986. A taxpayer wanted to sell her company, but the buyer wanted to purchase the company's assets. The obvious solution was for the taxpayer to liquidate the corporation, receive its assets, and sell them to the buyer. If the two steps were too interlinked, however, they were combined. *Compare* Comm'r v. Court Holding Co., 324 U.S. 331 (1945) (affirming the Tax Court judgment linking the steps), *with* United States v. Cumberland Pub. Serv., 338 U.S. 451 (1950) (upholding the Court of Claims decision declining to combine the steps on similar facts). Separating the steps to gain a benefit of a tax-free distribution of corporate assets exposed the taxpayer to a risk of holding these assets until their ultimate sale without the protection of a corporate shield. *See* BITTKER & EUSTICE, *supra*, ¶ 10.05[5][a].

[53] *See* BITTKER & EUSTICE, *supra* note 52, ¶ 10.08.

[54] These benefits included a bailout of corporate earnings at the tax-preferred capital gains rate, a step-up in tax basis of business assets, a recognition of loss built into the stock of a liquidated entity, and so on. *See id.* ¶ 12.64[1][a].

[55] Specifically, the government argued that the transaction should be treated as a nontaxable reorganization or a taxable dividend of all accumulated earnings and profits. Neither characterization would give rise to recognition of loss or increase in basis of corporate assets, and the latter would create additional taxable income for the tax-

But taxpayers could bolster their cases in several ways. First, they could hold the business in a noncorporate form for some time prior to reincorporating it.[56] Second, they could shut it down completely and then restart the enterprise by forming a new corporation.[57] If the termination was real, or if taxpayers operated an unincorporated business long enough, courts refused to combine the steps. Strengthening the tax arguments came at a cost, however. Operating an unincorporated business exposed taxpayers to unlimited liability.[58] Allowing the business to remain entirely dormant raised a risk of losing clients, contracts, employees, and new business opportunities.[59] All of these undesirable possibilities are examples of business risk.[60] Accepting this risk has enabled taxpayers to claim many tax benefits resulting not only from the liquidation-reincorporation and drop-and-sell two-steps, but from other transactional patterns as well.[61]

Note that, unlike market risk imposed by clear statutory rules considered in the previous Section, business risk typically arises from judicial action. In fact, just in dealing with the liquidation-reincorporation controversy, courts have focused on an ambiguous statutory term on some occasions[62] and disregarded the transactions altogether as

payer. *See, e.g.*, Simon v. Comm'r, 644 F.2d 339, 341-43 (5th Cir. Unit B Apr. 1981); Moffatt v. Comm'r, 42 T.C. 558, 573-82 (1964); Rev. Rul. 76-429, 1976-2 C.B. 97; BITTKER & EUSTICE, *supra* note 52, ¶ 12.64[1][c].

[56] *See, e.g.*, Swanson v. United States, 319 F. Supp. 959, 960 (E.D. Cal. 1970) (explaining that taxpayer operated as sole proprietor "for a time"); Kind v. Comm'r, 54 T.C. 600, 605 (1970) (recognizing a seven-month gap between liquidation of a flower shop and incorporation of its successor); Mathis v. Comm'r, 19 T.C. 1123, 1129 (1953) (documenting a nine-month gap between liquidation of a lumber company and incorporation of its successor).

[57] *See, e.g.*, Pridemark, Inc. v. Comm'r, 345 F.2d 35, 38-42 (4th Cir. 1965).

[58] *See, e.g.*, *Swanson*, 319 F. Supp. at 960 (explaining that the taxpayer decided that operating an unincorporated business following the liquidation "was unsatisfactory, primarily because it required him to risk all his personal assets in his new ventures"); *Kind*, 54 T.C. at 605 (finding that the taxpayer operated an unincorporated business for seven months "without the protection of a corporate umbrella").

[59] *See, e.g.*, *Pridemark*, 345 F.2d at 38-39, 41-42.

[60] I introduce the concept of business risk through a series of examples because it is, essentially, a catchall category. Business risk is an unwanted business-related uncertainty other than market risk, credit risk, *see infra* note 76, and counterparty risk, *see infra* text accompanying note 73.

[61] See, for example, United States v. Cumberland Pub. Serv., 338 U.S. 451 (1950) and Comm'r v. Court Holding, 324 U.S. 331 (1945), discussed in note 52, *supra*.

[62] The term is "reorganization." *See* BITTKER & EUSTICE, *supra* note 52, ¶ 12.64[2][b] (referring to courts' use of three different types of reorganizations to characterize a liquidation followed by a reincorporation). The "immediately after the exchange" clause of § 351 is another example of a statutory term interpreted to impose business risk.

"shams" on others.[63] But most often, courts have invoked broad tax common law doctrines of substance-over-form and, especially, step transaction.[64] These doctrines do not speak the language of risk and do not look anything like the detailed statutory rules discussed earlier.[65] Yet they have an effect of forcing taxpayers to bear risk, and I will treat them as just another kind of risk-based rule in the remainder of the Article.

C. *Counterparty Risk*

Market and business risks are not the only kinds of uncertainty that taxpayers are willing to accept as a price of gaining tax advantage. One of the most popular techniques used to deal with transactions that have unfavorable tax consequences is to break them into separate steps. In some contexts, as in the liquidation-reincorporation example, all steps are within the control of a single taxpayer or group of taxpayers. These taxpayers either assume no risk at all, or they take on business risk. But in many other instances, separating the steps involves a kind of uncertainty very different from that discussed thus far.

For instance, a publicly traded acquiring corporation (the "Acquirer") may decide to purchase a smaller company (the "Target"). The Target's owner (the "Seller") generally prefers cash consideration, but would like to have an opportunity to defer her gain from the sale, perhaps until the following tax year. To do this, the Seller must accept stock consideration instead. Can she have it both ways? Possibly. The parties will split the transaction into two steps. First, the Seller will transfer the Target to the Acquirer in exchange for the Acquirer's stock. Second, the Seller will sell that stock for cash. For tax purposes, the Seller will take a view that the transaction in the first step is a tax-free reorganization and will recognize gain only upon the later sale. To execute this sale without violating the securities laws, however, the Seller will need the Acquirer's assistance.[66] The Seller's

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[63] *See* BITTKER & EUSTICE, *supra* note 52, ¶ 12.64[1][c].

[64] *See id.*

[65] The step transaction doctrine, for instance, applies when the steps are "interdependent," or when a court is convinced that "the end result" of a sequence of steps was predetermined before the first step was made. For a discussion, see *id.* ¶ 12.61[3].

[66] The Acquirer's stock received by the Seller will be "restricted," and the Acquirer will need to file a registration statement with the SEC before this stock can be sold to the general public. *See* McDonald's Rests. of Ill., Inc. v. Comm'r, 688 F.2d 520, 522 (7th Cir. 1982); Penrod v. Comm'r, 88 T.C. 1415, 1419 (1987); Heintz v. Comm'r, 25 T.C. 132, 138 (1955).

business preference is to ensure this assistance in advance. Yet if the transaction is too prearranged (if, for example, the Acquirer is *legally bound* to assist the Seller in disposing of the Acquirer's stock), a court will invoke the step transaction doctrine, disregard the intermediate stock transfer, and defeat the Seller's tax planning strategy.[67]

To take another example, consider a corporation whose manager (the "Liquidator") wants to terminate the corporation's wholly owned subsidiary and recognize a taxable loss. The plan is to sell all of the subsidiary's assets and distribute cash in a complete liquidation. However, as long as the parent corporation owns more than 80% of the subsidiary shares, it will not be allowed to deduct the loss.[68] The solution comes in the face of the Liquidator's long-term customer (the "21-Holder") who purchases 21% of the subsidiary stock, waits, and, in the second step, receives the liquidation proceeds. Because the corporation owns only 79% of the subsidiary at the time of liquidation, the desired loss is deductible. If there is enough uncertainty surrounding the eventual liquidation when the Liquidator sells the 21% interest, this strategy works.[69]

Yet another example brings us back to wash sales. A taxpayer (the "Wash Seller") wants to recognize a loss on one of her stocks, but does not want to sell it. Cognizant of the wash sale rule, she sells the loss

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[67] *Compare McDonald's Rests.*, 688 F.2d at 525 (holding that, because there was too much certainty regarding the second step, the transaction was a taxable cash sale), *and Heintz*, 25 T.C. at 142-43 (holding that, because there was too much certainty regarding the second step—even though the planned public sale of the Acquirer's stock by the Seller fell through and the Acquirer arranged for a private sale later—the Seller was not entitled to the benefits of a tax-free reorganization), *with Penrod*, 88 T.C. at 1437 (finding that there was not enough certainty regarding the second step, respecting separate steps, and giving the Seller the benefit of nonrecognition of gain in the first step). Similar issues arise in the so-called bootstrap acquisitions, where certainty of the second-step sale of a corporation determines whether a pre-sale dividend paid by that corporation to the selling shareholder is respected or treated as part of the purchase price. *Compare* Steel Improvement & Forge Co. v. Comm'r, 314 F.2d 96, 98 (6th Cir. 1963) (treating the dividend as part of the purchase price), *with* Walker v. Comm'r, 544 F.2d 419, 422 (9th Cir. 1976) (respecting the dividend form). *See generally* BITTKER & EUSTICE, *supra* note 52, ¶ 8.07[2][a]. For an example of cooperative tax planning in international context, see *Koehring Co. v. United States*, 583 F.2d 313, 315-17 (7th Cir. 1978), describing how a U.S. company relied on its long-term U.K. partner to circumvent the controlled foreign corporation provisions.

[68] For a detailed discussion, see BITTKER & EUSTICE, *supra* note 52, ¶ 10.21[3][a].

[69] *See* Granite Trust Co. v. United States, 238 F.2d 670, 674 (1st Cir. 1956) (allowing the loss); Comm'r v. Day & Zimmermann, Inc., 151 F.2d 517, 519-20 (3d Cir. 1945) (same); BITTKER & EUSTICE, *supra* note 52, ¶ 10.21[3][a] (referring to the *Day & Zimmermann* decision as "surprising" but conceding that it "now seems sanctified by the passage of time").

security to an old friend (the "Wash Buyer"), and the parties agree—informally—that the taxpayer will buy the stock back for the same price in thirty-one days. If the repurchase is a forgone conclusion, the loss is disallowed.[70]

The common feature of all these fact patterns (and of many others[71]) is that in each case, a taxpayer (the Seller, the Liquidator, and the Wash Seller) changes the transaction to achieve a better tax result. The key to the strategy is to leave a critical aspect of the deal outside of the formal, legally enforceable agreement. This approach leads to the creation of "relational contracts"—a term widely used in the contract law scholarship. Charles Goetz and Robert Scott defined a relational contract as an agreement between parties who are "incapable of reducing important terms of the arrangement to well-defined obligations."[72] When it comes to tax planning, the parties are sometimes "incapable" of formalizing a given term—or, rather, unwilling to do so—because documenting it would produce adverse tax consequences. I will refer to tax strategies of this type as *relational tax planning*. Thus, relational tax planning occurs when taxpayers deliberately avoid formalizing certain aspects of their transactions because doing so would produce undesirable tax results.

Like all relational contractors, relational tax planners must accept risk. The uncertainty comes, however, not from business exigencies or price fluctuations, but from reliance on a contractual counterparty. The Acquirer may "defect" and renege on a soft promise to assist in selling its stock received by the Seller in the first step. Therefore, the

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[70] *See* Stein v. Comm'r, 36 T.C.M. (CCH) 992, 995 (1977) (disallowing the loss).

[71] For instance, consider an isolated sale-repurchase agreement (or "repo"). Imagine a company that needs to borrow $2 million, and has $2 million worth of municipal bonds that it can pledge as collateral (but does not want to sell). The company has a close relationship with a bank. The policy of the company's president, however, is not to borrow. Besides, the bank's lending limit to a single customer is only $800,000. One solution would be for the company to sell the bonds to the bank for $2 million and simultaneously enter into a contract to buy them back for the same price, allowing the bank to keep the tax-exempt interest on municipal bonds. This transaction will probably be treated as a secured loan for tax purposes, however, and the interest received by the bank on the municipal bonds will be taxable. An alternative solution would be for the parties not to enter into a repurchase agreement. Instead, the bank will retain the right to sell the bonds back to the company for $2 million, but the company will not be able to compel the bank to do so. Without this right, the company will assume a risk that the bank will decide to keep the bonds. *See* Citizens Nat'l Bank of Waco v. United States, 551 F.2d 832, 843 (Ct. Cl. 1977) (refusing to treat such a transaction as a secured loan).

[72] Charles J. Goetz & Robert E. Scott, *Principles of Relational Contracts*, 67 VA. L. REV. 1089, 1091 (1981).

Seller is at risk of being unable to cash out as (or as soon as) she would have preferred. Similarly, the Liquidator may break the promise of a speedy cash-only liquidation, so the 21-Holder is at risk of being stuck with the unwanted shares, or receiving a liquidating distribution of the subsidiary's assets rather than cash. The 21-Holder, however, may also defect and sell his 21% interest to a third party that may be uncooperative in facilitating the liquidation. The friendly wash sale may go awry, too. The Wash Buyer may refuse to resell, and the Wash Seller may refuse to repurchase.

I will refer to this type of uncertainty as *counterparty risk*. To simplify the discussion, I will assume that a taxpayer (the "Taxpayer") is always the party structuring the transaction, deciding how much risk to accept, and ultimately incurring a risk of relying on her contractual counterparty (the "Counterparty"). This assumption is hardly a stretch. The Counterparty may always condition his assistance on eliminating any exposure to the risk of the Taxpayer's defection.[73] Even if both parties assume counterparty risk, it appears highly unlikely that, when the Taxpayer requests the Counterparty's assistance, the resulting transaction imposes more risk on the Counterparty than on the Taxpayer. If so, we can think of counterparty risk borne by Taxpayers as the net of the two offsetting counterparty risks.

Is counterparty risk different from market and business risks in a meaningful way? They all have something in common. The Counterparty may defect because unexpected market fluctuations or business exigencies make the promised performance too costly. This danger reflects market and business risks. But the critical components of counterparty risk depend on factors very different from asset prices or commercial misfortunes. Most importantly, the information available to the Taxpayer and the Counterparty is almost always asymmetric and often imperfect. The Taxpayer will need to decide whether to accept counterparty risk without knowing as much about the Counterparty as the Taxpayer would like. And even if the Taxpayer assures herself that the Counterparty is a reliable cooperator at the time they take the first step, the Counterparty may later defect due to changed prefer-

[73] For instance, the Wash Buyer may agree to purchase the loss security only if the Taxpayer gives her a free put option to resell it back to the Taxpayer for the same price. An at-the-money put option does not defeat the tax strategy, and it eliminates the Counterparty's exposure to the Taxpayer's defection. *Cf.* Rev. Rul. 85-87, 1985-1 C.B. 268 (holding that § 1091 disallows a loss from a sale of stock if the taxpayer simultaneously sells an in-the-money put option on the same stock and there is no substantial likelihood that the put will not be exercised).

ences or new information. Or she may act opportunistically and hold up the Taxpayer, trying to extract a quasi-rent.[74] In other words, the key elements of counterparty risk depend on the Counterparty's idiosyncratic, unobservable attributes and strategic behavior rather than on the actions of third parties not involved in the risk-generating transaction, as is true of market and business risks.[75]

Taxpayers in all three examples considered in this section accept counterparty risk. All three strategies are instances of relational tax planning. But each example is different from the others in important respects. The Acquirer and the Seller in the first scenario are unfamiliar with each other. They are strangers who agree to cooperate in carrying out an isolated transaction. In contrast, the 21-Holder is the Liquidator's long-term customer. They have a long-term commercial relationship. The Wash Seller and the Wash Buyer also know each other well, but their connection is purely social. The significance of these distinctions will become clear as the discussion progresses.[76]

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[74] For a definition of opportunistic behavior, see OLIVER E. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM 47-49 (1985) ("By opportunism I mean self-interest seeking with guile."). For a discussion of holdups, see Benjamin Klein, *Why Hold-Ups Occur: The Self-Enforcing Range of Contractual Relationships*, 34 ECON. INQUIRY 444 (1996) [hereinafter Klein, *Why Hold-Ups Occur*]. For an explanation of quasi-rents, see Benjamin Klein, Robert G. Crawford & Armen A. Alchian, *Vertical Integration, Appropriable Rents, and the Competitive Contracting Process*, 21 J.L. & ECON. 297, 298-302 (1978).

[75] "'[S]trategic behavior' is concerned with influencing another's choice by working on his expectation of how one's own behavior is related to his." THOMAS C. SCHELLING, THE STRATEGY OF CONFLICT 15 (1980 ed.). Relational contractors have developed several ways to control strategic bargaining and asymmetric information problems. *See, e.g.*, Victor P. Goldberg, *Price Adjustment in Long-Term Contracts*, 1985 WIS. L. REV. 527, 531 (arguing that parties "enter into [long-term] agreements to achieve the benefits of cooperation," not "because of their concern for the future course of prices"); Klein, *Why Hold-Ups Occur*, *supra* note 74, at 458-59 (explaining how contractors shift private enforcement capital to alleviate contracting difficulties); Oliver E. Williamson, *Credible Commitments: Using Hostages To Support Exchange*, 73 AM. ECON. REV. 519, 524, 531 (1983) [hereinafter Williamson, *Credible Commitments*] (describing how hostages assure contractual performance). More generally, transactors adopt various institutional frameworks (or governance structures) to overcome the difficulties of imperfect bargaining. *See* Oliver E. Williamson, *Transaction-Cost Economics: The Governance of Contractual Relations*, 22 J.L. & ECON. 233, 234-35, 247-54 (1979) [hereinafter Williamson, *Transaction-Cost Economics*]. Yet the bargaining problems cannot be eliminated entirely. Thus, the term "counterparty risk" should be viewed as referring to the *residual* risk that remains after the parties have reduced uncertainty to the extent possible.

[76] *See infra* text accompanying notes 259 & 265-270. Yet another type of uncertainty arises whenever a taxpayer transacts with third parties who may default on their binding contractual obligations. This is *credit risk*. Occasionally, taxpayers who accept it escape unpleasant tax consequences. For example, § 163(*l*) grants interest deduc-

D. *Multilateral Counterparty Risk*

The statutory provisions and judicial precedents considered below will appear to be an eclectic collection even to a knowledgeable tax observer. And they certainly do not belong to any accepted doctrinal category. Yet all tax-planning strategies discussed in this Section share the same characteristic: they involve taxpayers who rely on counterparties in settings where their interactions are observable by members of the group that has adopted certain rules of behavior fitting under the broad rubric of social norms.

For example, a controlling shareholder (the "Parent") of a family-owned business may want to gradually transfer control over the business to the younger generation (the "Children"). If the business is profitable and the Children do not have a lot of cash (not an uncommon situation), the easiest way to accomplish this goal is for the Children to acquire just a few shares each and for the company to gradually redeem the Parent's stock. These redemptions, however, will be treated as dividends[77]—a tax-unfavorable result. A complete stock redemption generally receives a tax-preferred sale characterization.[78] Yet the Parent is not ready to give up management and control of the company. The promising strategy is to redeem all of the Parent's

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tions to issuers of certain debt-equity units only if they make debt and forward components separable, accepting credit risk of public investors who may default and refuse to perform under the forward. For a discussion, see Schizer, *Frictions*, *supra* note 10, at 1330-31 (explaining that because the corporate issuer will have no assurances that public investors will make payments if an issuer's stock price declines, "naked" publicly traded forwards are "unworkable"). To the extent that credit risk is conceived of as arising because of counterparties' possible insolvency or bankruptcy (which, one may assume, counterparties do not deliberately bring upon themselves), it is very similar to business risk. However, credit risk also reflects a possibility that a solvent counterparty will simply breach its contract with the taxpayer. While existence of an enforceable contractual obligation makes this type of risk different from counterparty risk, an opportunity for strategic actions by the counterparty is present in both cases. Thus, credit risk is better understood as a hybrid between business and counterparty risks. I will not discuss it further because analysis applicable to each of the "basic" risks applies to credit risk to the extent it reflects each basic type in any given case.

77 *See* I.R.C. § 302(b) (2000) (defining several tests that must be met in order for a corporate distribution not to be treated as a dividend).

78 *See id.* § 302(b)(3). Since 2003, dividends are often taxed at a lower capital gains rate, so the disparity between the dividend and sale treatments is not as drastic as it has been for years. However, the entire amount of the dividend is includable in gross income (assuming the company has sufficient accumulated earnings and profits, *see id.* § 316(a)), while only the excess of the amount received in a full redemption over the shareholder's basis in the redeemed stock is generally subject to tax, *see id.* § 1001(a). Thus, a sale treatment continues to be tax-preferred for individual shareholders.

stock, with an understanding that the Parent will reacquire some of the shares soon thereafter and that the Children will operate the business in (close) consultation with the Parent in the meantime. Even though understandings like this are unwritten, ambiguous, and unenforceable, they are clearly strengthened by the fact that uncooperative actions by the Children will lead to much more than the Parent's displeasure. Rather, the entire fabric of the (often extended) family will be at risk. Not surprisingly, Congress considered implicit agreements of this type so powerful that it decided to treat even a full redemption of the Parent's interest as a dividend.[79]

Family norms are not the only ones recognized by the tax law. A custom developed in the repo market provides another example. A repo is a sale of securities followed by a later repurchase for the same price (sometimes increased by an interest component). The market practice that emerged among commercial banks and municipal bond dealers who entered into thousands of repos over decades of doing business was to eschew formal repurchase agreements.[80] The parties relied on an implicit understanding that the repo'd municipal bonds would be repurchased on either party's request for the initial sale price.[81] Violators of this informal custom faced a nearly certain expulsion from the market. Courts recognized the custom's strength, concluded that taxpayers did not incur a meaningful risk by relying on a tacit understanding (rather than a legally enforceable contract) to repurchase, and denied the desired tax benefits.[82]

Another norm exists between tax-exempt charities and wealthy donors (or so it appears based on the number of cases with strikingly similar fact patterns). Well-to-do benefactors donate appreciated securities to charities on an understanding that the charities will follow the benefactors' wishes regarding a quick disposition of these securi-

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[79] *See id.* §§ 302, 318; *see also* United States v. Davis, 397 U.S. 301 (1970). A limited exception to this draconian rule is discussed below. *See infra* text accompanying note 223.

[80] For a detailed description, see Raskolnikov, *The Cost of Norms*, *supra* note 6, at 625-27.

[81] The market practice reverted to fully documented repurchase agreements to clarify the uncertain legal status of repos highlighted by a high-profile bankruptcy. *See* MARCIA STIGUM, THE REPO AND REVERSE MARKETS 218-21 (1989) (describing the 1982 Lombard-Wall bankruptcy and the development of a new standardized repo agreement).

[82] *See* First Am. Nat'l Bank of Nashville v. United States, 467 F.2d 1098, 1101 (6th Cir. 1972); Union Planters Nat'l Bank of Memphis v. United States, 426 F.2d 115 (6th Cir. 1970); Am. Nat'l Bank of Austin v. United States, 421 F.2d 442, 453-54 (5th Cir. 1970). *But see* Am. Nat'l Bank of Austin v. United States, 573 F.2d 1201, 1205-07 (Ct. Cl. 1978) (holding for taxpayer on similar facts).

ties and a certain use of the proceeds.[83] If everything works as planned, donors end up using charities to shelter an otherwise taxable gain from the sale of securities.[84] There is always a chance, however, that the charity will not cooperate. As in repo cases, the government has tried to convince courts that the donor and charity had a tacit agreement and that the risk that a charity would deviate from this agreement was too low. Unlike in the repo controversy, courts mostly took the taxpayer's side, often stressing that the donor had no legally enforceable right to compel the charity to act as the donor desired.[85]

I will call the risk assumed by the Parent, repo market participants, and wealthy donors a multilateral counterparty risk, or simply *multilateral risk*. It is a form of counterparty risk because it involves reliance on another person (rather than exposure to impersonal market fluctuations or business contingencies). Thus, multilateral risk accompanies relational tax planning. The difference is that cooperation (or defection) by the Counterparty in this case is observed by other members of a group (Children's family members, repo market participants, or donors and charitable organizations)—a feature that gives rise to the unique costs and benefits discussed below. Because multilateral risk is closely related to counterparty risk, I will focus mostly on the latter type, except where the differences between the two become relevant.

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[83] The charity may use the money to purchase a taxpayer's yacht, *see, e.g.*, Blake v. Comm'r, 697 F.2d 473, 474 (2d Cir. 1982), or a building owned by the taxpayer, *see, e.g.*, Carrington v. Comm'r, 476 F.2d 704, 709 (5th Cir. 1973), or the charity may simply cooperate with the taxpayer in liquidating the corporation that issued the donated securities, *see, e.g.*, Grove v. Comm'r, 490 F.2d 241, 243-44 (2d Cir. 1973); DeWitt v. United States, 204 Ct. Cl. 274, 279-89 (1974); Palmer v. Comm'r, 62 T.C. 684, 685-90 (1974).

[84] The charity's cooperation is important because a sale of appreciated securities by a taxpayer produces a taxable gain, while a sale of the same securities by a tax-exempt charity has no tax consequences. If a charity sells the securities and uses the proceeds to, say, purchase a building from the donor, the end result is that the donor parts with the building (which he essentially contributes to the charity) and sells the securities for cash without recognizing gain on that sale.

[85] Among the charitable donation cases cited above, *Blake* is the only government win. The IRS's attempt to rely on this case without repealing a revenue ruling acquiescing in the earlier taxpayer-favorable decisions prompted a stiff rebuke from the Tax Court. *See* Rauenhorst v. Comm'r, 119 T.C. 157, 169-73 (2002).

III. THE PROBLEM OF RELATIONAL TAX PLANNING

A. *What Is the Problem?*

While the fundamental difference between various types of risk has not attracted much scholarly attention, taxpayers seized the opportunity to exploit this difference long ago. Inevitably, this made tax planning easier.

The wash sale rule again provides a convenient point of departure. The rule imposes a waiting period and disallows certain forms of hedging, but says little about who could be the buyer of the depreciated security.[86] The omission invites an obvious "solution": sell the security to a friend and buy it back in thirty-one days. This is the friendly wash sale example. In the real friendly wash sale case, the court handed a decisive victory to the IRS even though it had to stretch the statutory language considerably.[87] The extra effort was well justified. Earlier, I discussed the wash sale rule as a type of provision that imposes market risk. Yet the uncertainty assumed by the taxpayer who entered into the friendly wash sale was different—it was what I have called counterparty risk. While the court did not analyze the transaction in these terms, it recognized that the taxpayer's strategy significantly reduced the amount of risk she incurred. That diminished risk was too low a price to obtain the desired tax benefit.

This example is a stark illustration of why relational tax planning presents a serious threat to the efficacy of risk-based rules. Clearly, the vast majority of these rules are designed to impose market risk. Many provisions in the Code and Treasury regulations explicitly re-

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[86] The related party rules make sure that the purchaser is not the seller's close relative, *see* I.R.C. § 267 (2000), but beyond that anything is fair game, or at least it so appears on the face of the statute. For a discussion of the relevant cases and a proposal to add a broad related-party rule to the wash sale regime, see Schizer, *Wash Sale Rules*, *supra* note 3, at 75-76.

[87] The court announced, for instance, that the wash sale loss was allowed only if "there was no express or *implied* agreement to buy back" the loss security, without offering any support for this proposition. Stein v. Comm'r, 36 T.C.M. (CCH) 992, 994 (1977) (emphasis added). Section 1091 provides that a loss is disallowed if, within the thirty-day period, "it appears that . . . the taxpayer has acquired . . . or has entered into a contract or option to so acquire, substantially identical stock or securities." I.R.C. § 1091(a). While the "it appears" clause suggests that the provision should be read broadly, it was clear that the taxpayer had nothing close to an enforceable contract to repurchase the security for the same price. The *Stein* court cited no authority supporting its conclusion that an "implied agreement" is a "contract" within the meaning of § 1091.

fer to market risk components such as risk of loss and opportunity for gain.[88] Congress protects the rules' integrity by forbidding excessive reduction of market risk through hedging and, sometimes, diversification.[89] Numerous references to market risk in the legislative history eliminate any doubt about the congressional focus on that type of uncertainty.[90] Moreover, the main academic critique of risk-based rules is that they are incapable of subjecting taxpayers to a meaningful market risk.[91] Thus, commentators also view these rules as designed to impose market risk.[92]

Understanding that most risk-based rules are written with market risk in mind is important for a simple reason: it means that the rules are calibrated based on this assumption. That is, when Congress decided that waiting for thirty days is long enough to deduct a wash sale loss, it evaluated the resulting risk by reference to fluctuations in stock prices, not the strength of the wash seller's relationship with her potential counterparty.

But why does it matter? Counterparty risk, it appears, is as good a deterrent as any other type of uncertainty. We can view various risks as different currencies. When we shop at a duty-free store, we do not think that because prices are listed in dollars and euros we can reap huge savings by paying in one currency or the other. Relational tax planning presents a problem only if counterparty risk is likely to be lower than the corresponding market risk most of the time. Is this a reasonable assumption?

If the strategy involves a fungible asset, the answer is unambiguously yes. This is so because if the Counterparty defects, the Taxpayer always has an option of acquiring an identical asset on the

[88] *See, e.g.*, I.R.C. §§ 246(c)(4), 1058(b)(3), 1092(c)(2), 1259(c)(3).

[89] *See id.* § 246(c)(1)(B) (waiting period suspended while the "taxpayer is under an obligation . . . to make related payments with respect to positions in substantially similar or related property"); *id.* § 901(k)(1)(A)(ii) (same); Treas. Reg. § 1.246-5 (1995) (defining positions in "substantially similar or related property" to include certain portfolios of stocks).

[90] *See, e.g.*, *supra* note 26.

[91] *See* articles cited *supra* notes 2 and 15.

[92] Several tax rules are designed to impose business risk. The term "reorganization" and the "immediately after the exchange" requirement of § 351 are prime examples. Only those corporate sales that qualify as "reorganizations" are eligible for a desirable deferral of gain. In order for the exchange to qualify, however, at least a portion of consideration received by the seller must come in the form of buyer's stock. That is, the seller cannot completely cash out. Ownership of stock involves business risk. For a discussion of the "immediately after the exchange" requirement, see *supra* text accompanying notes 51-52.

market.[93] If the asset is unique, however, the Counterparty may hold up the Taxpayer, forcing her to pay more than the asset's fair value.[94] Thus, it is possible that relying on the Counterparty will turn out to be worse than accepting market risk.

Possible, but unlikely. This is precisely why taxpayers choose to engage in relational tax planning. Their revealed preference is the best proof that the expected cost of counterparty risk incurred by relational tax planners is smaller than the expected cost of the corresponding market risk.[95] If the price of obtaining a tax benefit is set assuming that taxpayers transact at arm's length, but they actually engage in friendly exchanges with acquaintances, long-term clients, customers, or business associates, the real price turns out to be too low, and tax planning is underdeterred.

B. *How Serious Is the Problem?*

Congress, the Treasury, and the courts clearly recognize the threat of relational tax planning. They attack it both ex ante and ex post. Unfortunately, both types of response are ineffective.

Efforts to deter relational tax planning on an ex ante basis manifest themselves in a dizzying array of references to informal understandings scattered throughout the Treasury regulations. These provisions (numbered in dozens) warn that the government will take into

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[93] One of the key insights of transaction cost economics is that easily available alternatives eliminate the threat of opportunism. *See, e.g.*, Williamson, *Transaction-Cost Economics*, *supra* note 75, at 239 ("The crucial investment distinction is this: to what degree are transaction-specific (nonmarketable) expenses incurred. Items that are unspecialized among users pose few hazards, since buyers in these circumstances can easily turn to alternative sources, and suppliers can sell output intended for one order to other buyers without difficulty.").

[94] The holdup problem is one of the central issues studied by contract and organizational theorists. *See, e.g.*, *Introduction* to CASE STUDIES IN CONTRACTING AND ORGANIZATION 7 (Scott E. Masten ed., 1996); Alan Schwartz & Robert E. Scott, *Precontractual Liability and Preliminary Agreements*, 120 HARV. L. REV. 661, 685-87, 693-702 (2007).

[95] To be sure, taking on counterparty risk while transacting with total strangers (as in the Seller's sale of the Target to the Acquirer) is a risky proposition, so we may expect taxpayers to use it only as a last resort. Yet this point should not be overstated. Robert Scott has identified many cases where transactors deliberately entered into unenforceable contracts without an expectation of future dealings and with no tax benefits in sight. *See* Robert E. Scott, *A Theory of Self-Enforcing Indefinite Agreements*, 103 COLUM. L. REV. 1641, 1644 (2003). Of course, relational tax planning that involves friends (like the Wash Seller and Wash Buyer) or long-term business partners (like the Liquidator and 21-Holder) is a different story. The Taxpayer knows the Counterparty well, has an ongoing relationship with her, and has a good reason to believe that defection is unlikely.

account not just formal written contracts, but also "understandings" or "arrangements"[96] that may be "written or oral,"[97] "written or verbal,"[98] "formal or informal,"[99] "express or implied,"[100] "implicit or explicit,"[101] revealed by "a pattern of conduct,"[102] and whether or not they are "legally binding on the taxpayer."[103] Yet the government almost never relies on these provisions.[104] Moreover, on a few occasions the IRS disregarded tacit understandings that taxpayers themselves revealed to the government. The rulings cited—and ignored—direct references to informal arrangements.[105] The government's rare attempts to describe impermissible implicit agreements in detail produced voluminous, transaction-specific, and increasingly taxpayer-favorable guidance.[106] As a result, it is entirely unclear whether the varying

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[96] Treas. Reg. § 1.170A-5(a)(4) (as amended in 1994).

[97] Treas. Reg. §§ 1.483-1(a)(1), 1.1271-1(a)(1) (1994).

[98] Treas. Reg. § 48.4217-1 (as amended in 1985).

[99] Treas. Reg. § 1.382-3(a)(1)(i) (as amended in 1993).

[100] Treas. Reg. § 1.483-1(a)(1) (1994); Treas. Reg. § 1.957-1(b)(2) (as amended in 1997); Treas. Reg. § 20.2036-1(a) (as amended in 1960); Treas. Reg. § 301.6111-2(c)(1) (2003).

[101] Treas. Reg. § 1.355-7(h)(1)(i)(A) (2005).

[102] Treas. Reg. § 1.507-2(a)(8)(iv)(A)(3)(i) (as amended in 1981).

[103] Treas. Reg. § 1.6011-4(b)(3)(ii) (as amended in 2003).

[104] A review of dozens of regulatory references to informal understandings reveals that all but a few of these provisions have never been invoked by the government in litigation, formal guidance, or even informal guidance. For rare exceptions, see, for example, *Koehring Co. v. United States*, 583 F.2d 313, 317 (7th Cir. 1978) and *Guynn v. United States*, 437 F.2d 1148, 1150 (4th Cir. 1971). Note that in *Koehring*, the government's case that a U.S. taxpayer had an implied agreement with a foreign co-owner of a joint company was greatly helped by the fact, among others, that the foreign party's directors referred to their participation as "nominal" in the minutes of the Board of Directors meeting. 583 F.2d at 316.

[105] For example, in I.R.S. Priv. Ltr. Rul. 92-18-067 (Jan. 31, 1992), the IRS refused to find that donors reserved present interest in paintings—even though they retained them in their home until the donee-museum opened in the following year and even though the parties *expected* that the donors would do so—because the donee had a formal right to take control of the paintings. This ruling essentially ignored the statement in the regulations that a taxpayer-donor will be treated as reserving present interest if she "has an understanding, arrangement, agreement, etc., whether written or oral, with the charitable organization which has the effect of reserving to, or retaining in, such donor a right to the use, possession, or enjoyment of the property." Treas. Reg. § 1.170A-5(a)(4) (as amended in 1994).

[106] *See* BITTKER & EUSTICE, *supra* note 52, ¶ 11.11[3][d] (describing the government's struggle with regulations enacted under § 355(e) to clarify when taxpayers will be treated as having a plan to dispose of a newly received corporate stock, but which have been called "a parody" and "the Matrix").

references to informal understandings have identical scope and, if so, what it is.[107]

Even more troubling is the fact that while many risk-based rules at least attempt to reach informal arrangements, many more do not. The omission is particularly unfortunate because it allows taxpayers to argue that it is deliberate.[108] Whatever one might think about arguments based on negative inferences, they further embolden many relational tax planners.[109]

But the most disheartening conclusion is that the ex ante attempts to address relational tax planning are unlikely to succeed even if the government adds more references to tacit understandings and attempts to use them whenever possible. Finding these understandings is very difficult, and proving their existence in court even more so—realities that are not lost on taxpayers.[110] For all these reasons, the deterrent effect of the current statutory and

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[107] Thus, while the regulatory admonitions appear to deter relational tax planning through ex ante rules (rather than ex post standards), it is unclear whether they actually do so. The distinguishing feature of rules is that they give content to legal commands before individuals act. *See* Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557, 560 (1992). Whether the regulatory references to informal understandings actually have specific content depends on whether their meaning is (relatively) certain. If it is not, the apparent rule-like provisions are actually standards whose content will be determined only ex post. *See id.* at 601. Because the references in question have been used so rarely, it is unclear whether they establish a rule or a standard. I refer to them under the rubric of an ex ante approach to highlight the distinction from court-created doctrines whose content is even less certain, and thus, that are even more standard-like. This distinction also emphasizes the difference between regulatory (ex ante) and judicial (ex post) solutions.

[108] Congress and the Treasury know how to refer to tacit understandings well, the argument goes. They have done so on many occasions. If a given provision includes no reference to oral, implicit, or not legally binding arrangements, it must be because the government does not object to their use in this particular context.

[109] Quite possibly, this kind of argument was precisely the reason why the Wash Seller in the real friendly wash sale case was so confident in his strategy that he voluntarily revealed to the IRS the existence of an informal agreement to repurchase the loss security. *See* Stein v. Comm'r, 36 T.C.M. (CCH) 992, 994 (1977).

[110] In some cases the detection may be fairly easy, such as where taxpayers transact on non-arm's-length terms. A repurchase of a loss security from a Wash Buyer at the initial sale price, as well as a repurchase of municipal bonds by a repo seller, are examples of such transactions. Even here, however, the parties may make detection difficult by selling for the market price and making compensating side payments not reflected in any discoverable written agreement. On many other occasions, things will be even less clear. For instance, the fact that the Acquirer assists the Seller in selling the Acquirer's stock, or that a charity disposes of the donated securities exactly as the donor would have wished, may suggest—but certainly does not prove (as the government has learned on many occasions)—the existence of an informal understanding.

regulatory responses to relational tax planning is questionable at best.

Perhaps recognizing the severe difficulties of addressing the problem ex ante, courts have developed ways to do the same after the fact. The substance-over-form doctrine, and its narrower version, the step transaction doctrine, give courts ample discretion to take informal understandings into account. Yet they rarely do so. The judicial rhetoric is sweeping but misleading. Courts applying these doctrines purport to "bypass appearances"[111] and focus on "the objective economic realities of a transaction rather than [on] the particular form the parties employed."[112] However, even when opinions favor the government, they usually do so based on legally enforceable rights and obligations arising from the very documents whose form they disregard.

Moreover, the facts-and-circumstances test used by courts to discern the substance of the transaction is highly open ended. In the words of the leading treatise, "it is almost impossible to distill useful generalizations from the welter of substance-over-form cases."[113] Especially where informal arrangements become an issue, courts seem to pay particular attention to taxpayers' intent and purpose. In fact, one version of the step transaction doctrine—the end result test—is explicitly intent based.[114] As a result, courts occasionally give credence to taxpayers' self-serving assertions regarding their motive and intent—assertions that are often impossible to verify.[115]

Granted, the government wins some cases that involve relational tax planning. But it also loses a lot. The charitable donation decisions are a sobering reminder that courts can be remarkably blind to apparent tacit understandings. In many other contexts,

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[111] TIFD III-E, Inc. v. United States, 459 F.3d 220, 236 (2d Cir. 2006).

[112] Frank Lyon Co. v. United States, 435 U.S. 561, 573 (1978).

[113] BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 4.3.3 (Supp. 3 2004).

[114] *See, e.g.*, McDonald's Rests. of Ill., Inc. v. Comm'r, 688 F.2d 520, 524 (7th Cir. 1982); King Enters. v. United States, 418 F.2d 511, 516 (Ct. Cl. 1969).

[115] *See, e.g.*, True v. United States, 190 F.3d 1165, 1180 (10th Cir. 1999) (rejecting in part the lower court's summary judgment in favor of the IRS because the taxpayer's intent regarding transfers among his controlled companies was unclear); Citizens Nat'l Bank of Waco v. United States, 551 F.2d 832, 841 (Ct. Cl. 1977) (upholding a transaction entered into "with no thought or purpose of tax evasion," even though when all was said and done the bank ended up lending funds to the taxpayer and receiving tax-exempt interest on that loan); Vaughn v. Comm'r, 81 T.C. 893, 910 (1983) (explaining that the Tax Court established an "independent purpose test" for intrafamily installment sales).

taxpayers prevailed in convincing judges that no such understandings existed even among family members and long-term associates.[116] Some tribunals gave full credence to formal transactions between entities under common control, ignoring their relationships entirely.[117] The Tax Court announced that in evaluating "legal rights and interests created by a written instrument," it will ignore most implicit arrangements altogether.[118] These decisions create a lot of room for creative relational tax planners. No doubt, many take advantage.

How serious of a problem is this for our tax system? Most likely, very serious. While the analysis of relational tax planning is still in its early stages, it is already quite clear that the problem is widespread, extending well beyond the relatively well-understood phenomenon of intrafamily tax structuring. Relational tax planning is key to major tax-minimization strategies developed by financial markets in recent years. Variable delivery prepaid forwards, actively traded cross-border swaps, and structured loans by offshore hedge funds are just some examples.[119] Charitable organizations and wealthy benefactors have relied on relational tax planning for years. And it is no secret that the entire tax shelter industry flourished in the late 1990s and early 2000s due in large part to numerous tacit understandings among various participants.[120]

Case law analysis provides further evidence. A significant portion of the hundreds of cases invoking the substance-over-form and step transaction doctrines involve relational tax planning.[121] These cases, no doubt, represent just a small tip of the proverbial iceberg. If it occurred to one taxpayer to circumvent the wash sale rule by

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[116] *See, e.g.*, Granite Trust Co. v. United States, 238 F.2d 670, 677 (1st Cir. 1956) (respecting a transitory sale of corporate stock to a long-term customer); *Citizens Nat'l Bank of Waco*, 551 F.2d at 843 (respecting the form of a repo entered into by a bank and its long-term client); Richard Hansen Land, Inc. v. Comm'r, 65 T.C.M. (CCH) 2869, 2874 (1993) (upholding a taxpayer-favorable treatment of a family trust); Bowen v. Comm'r, 78 T.C. 55, 85 (1982) (approving an inter-spousal installment sale).

[117] *See, e.g.*, *True*, 190 F.3d at 1180-81; *see also* Comm'r v. W.F. Trimble & Sons Co., 98 F.2d 853 (3d Cir. 1938) (allowing a loss on a wash sale of a security from one wholly owned corporation to another, followed by its repurchase slightly more than a month later).

[118] Estate of Craft v. Comm'r, 68 T.C. 249, 263 (1977). For a discussion of this opinion, see Raskolnikov, *The Cost of Norms*, *supra* note 6, at 635-36.

[119] For a detailed explanation, see Raskolnikov, *The Cost of Norms*, *supra* note 6, at 613-22.

[120] *See id.* at 674.

[121] A Westlaw search of the *Federal Tax Cases Combined* database reveals 186 cases invoking the step transaction doctrine and 142 cases discussing the substance-over-form doctrine (without also mentioning the step transaction doctrine).

selling a loss security to a friend with an informal understanding to repurchase it upon the expiration of the waiting period, we can be sure that the same idea occurred to many others (who, unlike the taxpayer in the actual friendly wash sale case, were unwilling to admit openly the existence of an informal understanding). Moreover, many entrepreneurial minds have certainly realized that not just the wash sale provision, but many other waiting-period and other market-risk-imposing rules may be skirted using the same technique. In fact, it is remarkable how easily various relational tax planning strategies come to mind once one grasps the basic concept. These strategies cost the government billions of dollars in lost revenues.[122]

Relational tax planning is possible (and likely) whenever the tax law relies on risk-based rules. These rules pervade the Internal Revenue Code, the Treasury Regulations, and the tax common law. But their sheer number does not determine the magnitude of the problem. Most importantly, risk-based rules defend major fault lines of our income tax system. The realization requirement, double taxation of corporate income, worldwide taxation of U.S. residents, U.S. taxation of (certain) U.S.-source income of foreign taxpayers, tax ownership, the distinction between risky and riskless returns, as well as between capital and labor income, are all pro-

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[122] The government's recent inquiries into the schemes that may have allowed wealthy foreigners to escape as much as *one billion* dollars in the U.S. dividend withholding tax are likely to uncover some such strategies already described in the academic literature. For the reference to the government interest, see Anita Raghavan, *IRS Probes Tax Goal of Derivatives*, WALL ST. J., July 19, 2007, at C1. For the description of the strategies, see Raskolnikov, *The Cost of Norms*, *supra* note 6, at 618-22.

tected by risk-based rules.[123] All of these doctrines and distinctions are vulnerable to relational tax planners.

Regulatory warnings about implicit understandings and tax common law anti-abuse doctrines discussed above surely have some deterrent effect. Whether they come close to being effective is another matter. The many weaknesses of the current rules suggest that the government's responses to relational tax planning have been unsuccessful. Academics have done little to assist policymakers with devising alternative regimes.

IV. EVALUATING WELFARE CONSEQUENCES OF DIFFERENT TYPES OF RISK

In order to conceive of—and evaluate—novel solutions, we need a more sophisticated understanding of various types of risk. This Part begins the inquiry. It demonstrates that market, business, and counterparty risks systematically differ in their deterrent effects and social welfare implications. Business risk is a stronger deterrent than equally efficient market risk, and it is more efficient than equally deterring market risk. Because counterparty risk is particularly complex, it is difficult to draw general conclusions, at least as long as the current rules remain in place.

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[123] The following table provides a partial list of one-way risk-based rules and the implicated tax policy considerations, together with cross-references to specific examples:

Risk-Based Rule	**Tax Policy Issue Affected**	**Reference**
I.R.C. § 83	Taxation of capital vs. labor income (tax rate applicable to certain compensation based on whether it is subject to a substantial risk)	
§ 163(*l*)	Double taxation of corporate income	n.39
§ 246(c)(1), (2)	Double taxation of corporate income	n.32
§ 351(g)	Double taxation of corporate income	n.40
§ 465	Taxation of risky vs. riskless returns	n.41
§ 901(k), (*l*)	Worldwide taxation of U.S. residents	n.33
§ 1091	Realization requirement	nn.3-5
§ 1092	Realization requirement	n.37
§ 1258	Taxation of risky vs. riskless returns	n.38
§ 1259	Realization requirement	nn.34-35
§ 1260	Realization requirement	n.36
Substance-over-form doctrine, step transaction doctrine	A variety of issues, including:	
	Realization requirement	nn.49-52
	Double taxation of corporate income	nn.53-61
	Tax ownership	n.71

A. *Market Risk*

The basic economic effect of risk-based rules is well understood. Faced with a choice between forgoing tax planning and assuming market risk, some taxpayers prefer the former and others the latter. Those who remain undeterred incur risk-bearing losses—a form of deadweight loss.[124] They worry about adverse market changes but continue with their tax planning anyway. Risk-bearing losses resulting from incurring market risk (RBL_M) are a pure social waste.[125]

An additional—and similarly wasteful—response is to accept the requisite risk in form but to try minimizing it in substance. Increasingly sophisticated hedging strategies are being developed and sold to anxious taxpayers who want to diminish their market risk. These schemes come with high fees for promoters and lawyers, additional pointless transactions needed only to support the tax arguments, and other costs. Taxpayers' wasteful efforts of this type are not unique to risk-based rules. These are generic transaction costs of tax planning. They are roughly the same for taxpayers incurring all types of risk, and they enter into both private and social cost equations. Therefore, I will ignore these generic transaction costs in the remainder of the Article.

Note that the risk-bearing losses produced by risk-based rules are different from the standard risk-bearing cost associated with tax avoidance (or any possibly illegal behavior). That cost arises because taxpayers take aggressive positions and then worry about possible audits, litigation, penalties, and so on.[126] This uncertainty has nothing to do with whether the rules the taxpayers may have violated are risk based, or with whether a risk-based rule in question imposes one type of risk or the other.[127] Because the standard risk-bearing cost does not illuminate the analysis of risk-based rules, I will ignore it as well.

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[124] A risk-bearing loss (or a risk premium) arises because for a concave utility function, the expected income and the certainty equivalent diverge. *See* ROSEN, *supra* note 8, at 267-69.

[125] *See* Shaviro, *Risk-Based Rules*, *supra* note 1, at 674 ("Requiring taxpayers to bear undesired risk as the price of receiving favorable tax treatment creates excess burden.").

[126] *See* Louis Kaplow, *The Optimal Probability and Magnitude of Fines for Acts That Definitely Are Undesirable*, 12 INT'L REV. L. & ECON. 3, 9 (1992); A. Mitchell Polinsky & Steven Shavell, *The Optimal Tradeoff Between the Probability and Magnitude of Fines*, 69 AM. ECON. REV. 880, 880 (1979).

[127] For instance, a rule that determines whether a particular outlay is a (deductible) business expense or a (nondeductible) personal expenditure cannot be avoided by accepting risk. Yet an entrepreneur who deducted some questionable items worries about violating this rule just like an investor who hedged her appreciated stock position a bit too perfectly worries about triggering a constructive sale (i.e., violating a risk-

Losses from bearing market risk are not the only costs that may be incurred by tax planners who face market-risk-imposing rules. When, for example, a taxpayer sells a loss security onto the market, there is a chance (α_M) that the security will appreciate and the taxpayer will have to pay more to repurchase it than what she received from its earlier sale. That difference is a market loss (L_M). Of course, there is also a possibility ($1 - \alpha_M$) that the loss security will depreciate during the waiting period, and the taxpayer will gain G_M from that decline upon repurchase. The expected cost (or, if negative, benefit) of these possible outcomes is wholly separate from risk bearing, and it will exist even for risk-neutral taxpayers. It may be described as:

$$\alpha_M \times L_M - (1 - \alpha_M) \times G_M$$

Yet it is reasonable to ignore this component of market risk because its expected value is roughly zero. There is approximately the same 50% chance that a given security will appreciate or decline by any specific amount during a particular waiting period.[128] Most waiting periods are short, so the time value element is insignificant.[129] The same is true of the risk premium. Furthermore, some risk-based rules force taxpayers to take unwanted long positions,[130] while others do the opposite.[131] Therefore, even if slight appreciation is somewhat more likely, taxpayers stand to gain from it in some cases and lose in others. In sum, the expected gain or loss from market fluctuations is so close to zero that it can be disregarded.

Finally, whenever a taxpayer engages in tax planning aimed at circumventing a market-risk-imposing rule, there is a chance (β_M) that her plan will fail and she will end up paying tax T. The cost of this *expected tax liability* is $\beta_M \times T$. Therefore, the total private cost borne by tax planners facing market risk is:

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based rule). That is, both taxpayers are concerned about taking aggressive positions. In contrast, a taxpayer who deducts an uncontroversial business expense has nothing to worry about. But a taxpayer who clearly satisfies the wash sale rule and is entitled to a loss deduction still incurs a risk-bearing loss because she is forced to accept 31 days' worth of unwanted market exposure. This difference highlights a unique cost imposed on taxpayers by risk-based rules—the cost of incurring market risk.

[128] At least, this much is true of a typical (short) waiting period. For such periods, "the past rates of return on any stock conform closely to a normal distribution." BREALEY & MYERS, *supra* note 31, at 187. For longer intervals such as one year, the distribution would be skewed and would better approximate a lognormal distribution. *Id.* at 187 n.2.

[129] *See, e.g.*, I.R.C. § 246(c)(1) (2000) (forty-five days); *id.* § 901(k) (fifteen days); *id.* § 1091(a) (thirty days); *id.* § 1259(c)(3) (sixty days).

[130] *See, e.g.*, *id.* § 246(c); *id.* § 901(k), (*l*).

[131] *See id.* § 1091.

$$PC_M = RBL_M + \beta_M \times T$$

Risk-bearing losses (as well as generic transaction costs) are also social costs. Pointless transactions, efforts of shelter promoters, and disutility produced by uncertainty are all real costs to society. No diseases are cured, no inventions made, and no children educated as a result of these activities. But these are not the only components of the social cost of imposing market risk. The government also needs to enforce its rules. This involves audits, litigation, rulemaking, and the like.[132] I will group all these expenditures under the rubric of enforcement costs (EC_M). The expected tax liability, on the other hand, is not a social cost. It is merely an expected transfer from the tax planner to the government (that is, other members of society). This transfer does not affect the overall social welfare. Thus, the total social cost of deterring tax planning with market-risk-imposing rules is:

$$SC_M = RBL_M + EC_M$$

B. *Business Risk*

Business risk is similar to market risk in many respects. It produces risk-bearing losses (RBL_B) when, for example, taxpayers continue to own a business they no longer want (as they must do in the drop-and-sell scheme) or operate without the protection of the corporate veil (as they sometimes did in the liquidation-reincorporation structure). Enforcement costs of tax planning are also comparable for market and business risks. The same is true of the likelihood that the tax planning strategy will fail (that is, β_M is generally equal to β_B). There is, however, an important difference between the two types of uncertainty.

Incurring business risk means accepting a chance that the business contingency will be resolved in favor of, or against, the taxpayer. Unlike in the market risk case, however, the expected gain and loss are no longer offsetting. The liquidation-reincorporation sequence provides the most intuitive example. Business risk arises here because the taxpayer loses the protection of limited liability while she operates the business outside of corporate form. While this may lead to some savings, the net effect is clearly negative.[133] It is also entirely unrelated

[132] For a detailed discussion of enforcement and other costs, see Joel Slemrod & Shlomo Yitzhaki, *Tax Avoidance, Evasion, and Administration*, *in* 3 HANDBOOK OF PUBLIC ECONOMICS 1423, 1447-49 (Alan J. Auerbach & Martin Feldstein eds., 2002).

[133] The cost of losing limited liability was recognized by several courts. *See* cases cited *supra* note 58.

to risk bearing. In other words, even a risk-neutral taxpayer who never incurs risk-bearing losses will view a loss of a corporate veil as an expected cost. In contrast, a risk-neutral tax planner will remain entirely unaffected by market-risk-imposing rules. Thus, it is appropriate to include an additional variable into the private cost of incurring business risk—the expected (net) loss from the adverse resolution of a business contingency, or, in short, the *expected business loss*. This loss may be expressed as $\alpha_B \times L_B$, where α_B is the probability that the taxpayer will incur a business loss equal to L_B.

It may appear that this loss is absent in many business risk situations. In a drop-and-sell scenario, for example, a taxpayer must retain the business she no longer wants *after* it is incorporated. Here the protection of the corporate veil is gained, not lost. Yet even in this case the taxpayer incurs the expected business loss. Quite simply, if she valued limited liability highly enough, she would have incorporated the business long ago. Whatever her reasons were for not doing so, they made it worthwhile not to incorporate.[134] It follows that incorporating is an undesirable move, which is the same as saying that the taxpayer incurs an expected loss from making it. That loss, again, is wholly separate from the unwanted continuing exposure to the risk of the business that is needed to satisfy the "immediately after the exchange" requirement (i.e., that loss is different than RBL_B). Granted, in some cases the expected business loss may be zero. Yet in many transactions involving business risk there is clearly a loss. Thus, on average, the expected business loss is an additional cost incurred by taxpayers planning around business-risk-imposing rules. Therefore, the private cost of incurring business risk (PC_B) may be summarized as:

$$PC_B = RBL_B + \alpha_B \times L_B + \beta_B \times T$$

Does the expected business loss enter the social cost calculus as well? It does not. Whenever this loss materializes—say a liquidator-reincorporator has to pay a tort judgment out of personal assets because she operated her business in an unincorporated form—this payment is merely a transfer between two members of society. Whatever the tax planner loses, the tort victim gains. The transfer has no effect on overall social welfare. Therefore, the social cost of imposing business risk is, for our purposes, the sum of risk-bearing losses and

[134] Of course, the same argument applies to a taxpayer undertaking a liquidation-reincorporation sequence.

the enforcement cost of business-risk-imposing rules (EC_B), and it does not include the expected business loss:[135]

$$SC_B = RBL_B + EC_B$$

Needless to say, the picture can be easily made more complex. Continuing with the liquidator-reincorporator/tort victim example, the payment from one party to the other may affect social welfare for a variety of reasons. The marginal utility of the amount transferred may be higher (or lower) to the taxpayer than to the tort victim because, for instance, they have different wealth. The parties may have different utility functions. The social welfare function may assign different weights to utilities of the two individuals involved. Countless other objections may be made.[136] The same can be said of the earlier discussion of market risk and the following discussion of counterparty risk. While I will not deal with these complications here, they are clearly important. My goal, however, is to lay the groundwork. I will eschew additional complexity in order not to obscure the basic distinctions.

C. *Counterparty Risk*

Tax planners may reduce their taxes while incurring market or business risk in complete solitude. Relational tax planning, in contrast, requires cooperation. The Taxpayer must take a leap of faith and rely on the Counterparty, who will have a chance to reciprocate or betray the Taxpayer's trust. Either outcome will have consequences for both parties.

1. Private Benefits of Cooperation

Assume, first, that the Counterparty cooperates. His trustworthy behavior increases the Taxpayer's trust in the Counterparty.[137] Stronger trust has potentially broad implications for the entire relationship between these two transactors. As Kenneth Arrow observed,

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[135] It also does not include the expected tax liability for the same reason this liability is excluded from the social cost of market risk.

[136] For instance, one may argue that the mode of analysis that relies on utility and social welfare functions is inappropriate in the first place.

[137] *See, e.g.*, Frank B. Cross, *Law and Trust*, 93 GEO. L.J. 1457, 1491 (2005) ("'[V]oluntarily risking vulnerability . . . promote[s] the attribution of trustworthiness,'" while "[e]xposing oneself to risk . . . provides a prime mechanism for initiating trust." (quoting Svenn Lindstold, *Trust Development, the GRIT Proposal, and the Effects of Conciliatory Acts on Conflict and Cooperation*, 85 PSYCHOL. BULL. 772, 789 (1978))).

"Virtually every commercial transaction has within itself an element of trust, certainly any transaction conducted over a period of time."[138] While another noted economist, Oliver Williamson, argued that it is misleading to use the term "trust" in describing commercial relationships,[139] numerous scholars have pointed out a variety of ways in which trust (or, if one prefers, willingness to accept a risk of relying on a contractual counterparty) facilitates commercial exchanges.

Trust, they have argued, signals contractual flexibility,[140] conserves cognitive resources,[141] speeds up decision making,[142] facilitates searches for reliable business partners,[143] reduces monitoring costs,[144] lessens uncertainty and expense of judicial enforcement,[145] enhances transfer and credibility of private information,[146] diminishes the need for contingency planning and insurance,[147] and "creates opportunities for the exchange of goods and services that are difficult to price or enforce" using formal agreements.[148] In sum, all sorts of transaction costs are reduced if the transactors trust each other. It is also widely accepted that trust grows with use.[149] Each act of reliance and each instance of trustworthy behavior strengthen mutual confidence.[150]

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[138] Kenneth J. Arrow, *Gifts and Exchanges*, 1 PHIL. & PUB. AFF. 343, 357 (1972).

[139] *See* Oliver E. Williamson, *Calculativeness, Trust, and Economic Organization*, 36 J.L. & ECON. 453, 463 (1993) (introducing the term "calculative trust" and explaining why it is "a contradiction in terms").

[140] *See* G. Richard Shell, *Opportunism and Trust in the Negotiation of Commercial Contracts: Toward a New Cause of Action*, 44 VAND. L. REV. 221, 255 (1991).

[141] *See* Brian Uzzi, *Social Structure and Competition in Interfirm Networks: The Paradox of Embeddedness*, ADMIN. SCI. Q., Mar. 1997, at 35, 43.

[142] *See id.*

[143] *See* Ranjay Gulati, *Does Familiarity Breed Trust? The Implications of Repeated Ties for Contractual Choice in Alliances*, 38 ACAD. MGMT. J. 85, 107 (1995).

[144] Margaret M. Blair & Lynn A. Stout, *Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law*, 149 U. PA. L. REV. 1735, 1757 (2001).

[145] *See id.*

[146] *See* Brian Uzzi, *Embeddedness in the Making of Financial Capital: How Social Relations and Networks Benefit Firms Seeking Financing*, 64 AM. SOC. REV. 481, 490 (1999).

[147] *See* Larry T. Garvin, *Credit, Information, and Trust in the Law of Sales: The Credit Seller's Right of Reclamation*, 44 UCLA L. REV. 247, 341-42 (1996).

[148] Brian Uzzi, *The Sources and Consequences of Embeddedness for the Economic Performance of Organizations: The Network Effect*, 61 AM. SOC. REV. 674, 677 (1996).

[149] *See, e.g.*, Garvin, *supra* note 147, at 342 (citing Albert O. Hirschman, *Against Parsimony: Three Easy Ways of Complicating Some Categories of Economic Discourse*, 74 AM. ECON. REV. (PAPERS & PROC.) 89, 93 (1984)); Lawrence E. Mitchell, *The Importance of Being Trusted*, 81 B.U. L. REV. 591, 600 (2001).

[150] *See, e.g.*, Gulati, *supra* note 143, at 94 (citing Aravind Parkhe, *Strategic Alliance Structuring: A Game Theoretic and Transaction Cost Examination of Interfirm Cooperation*, 36

Successful relational tax planning makes the Taxpayer and the Counterparty better cooperators. If these parties have a multifaceted business relationship, a resulting incremental increase in trust facilitates their transactions *other than* the one in which the Taxpayer incurs counterparty risk as a cost of gaining a tax benefit. Granted, trust may affect some aspects of a relationship, while not extending to others.[151] Trusting the Counterparty to hold the Taxpayer's loss security for a month is not the same as relying on him to take care of the Taxpayer's child for the same period. Yet there is no reason to think that incremental trust generated by relational tax planning has zero spillover effects. Transactors are likely to view tax planning (at least as long as it is not overly aggressive) as just another cost-saving device. If so, cooperation enhanced by the specific relational tax planning episode will often extend to other informal interactions between the Taxpayer and the Counterparty.

These interactions, to be sure, may be bad for society. If relational tax planning makes the Taxpayer and the Counterparty better "partners in crime," it produces a unique social cost. This is a crucial question that will be addressed in detail below. The discussion here focuses on *private* benefits of relational tax planning. And these benefits are clearly positive, at least as long as the Counterparty cooperates.

2. Private Costs and Benefits of Defection

What if the Counterparty defects? Any rational Taxpayer will, no doubt, ask herself this question before engaging in relational tax planning. There is always a chance (α_C) that the Counterparty will betray the Taxpayer's trust and the Taxpayer will incur a loss (L_C). Does the *expected counterparty loss* ($\alpha_C \times L_C$) enter the Taxpayer's cost-benefit calculus in the same way as the expected business loss ($\alpha_B \times L_B$) does for those who incur business risk?

The answer is no, because of the unique nature of counterparty risk. In the business risk case, the tax planner can do nothing to influence the unknown future recipient of the amount L_B. Until the adverse business contingency is resolved, there is no one with whom to negotiate. Not so for counterparty risk. It arises from a Coasean bargain between two parties. In the absence of transaction costs (I will

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ACAD. MGMT. J. 794 (1993), for the proposition that a history of cooperation reduces perceptions of expected opportunistic behavior).

[151] *See, e.g.*, Cross, *supra* note 137, at 1503 (arguing that trust is multidimensional, meaning that a relationship may contain both trust and distrust).

consider them later), these parties will strike a deal whenever there is a surplus to be shared. The joint (private) surplus of relational tax planning is the excess of the Taxpayer's tax benefit over her risk-bearing loss from incurring counterparty risk (RBL_C).[152] The expected counterparty loss ($\alpha_C \times L_C$) does not enter the equation because, under perfect bargaining conditions, the Counterparty will always reimburse the Taxpayer for accepting that cost. For instance, at the margin (when the joint surplus is very small, say, $1), the Counterparty will be willing to make an up-front payment to compensate the Taxpayer for incurring the expected counterparty loss, as long as the Counterparty derives *some* net benefit from this trade.[153] That is, the Counterparty will surrender the expected gain from his possible defection in order to induce the Taxpayer to go forward with relational tax planning and share with the Counterparty a portion of the joint surplus (say, $0.50). Therefore, the expected loss from the Counterparty's defection will be fully taken into account by the Taxpayer ex ante, yet it will not amount to the additional private cost and will not affect decisions of marginal Taxpayers.[154]

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[152] More precisely, this joint surplus also includes the cooperation gain, *see infra* text accompanying note 162, and is reduced by the tax cost incurred by the Counterparty, if any.

[153] The net benefit is the excess of the expected counterparty loss ($\alpha_C \times L_C$) (which is a benefit to the Counterparty) over the payment made by the Counterparty to the Taxpayer at the inception of the trade.

[154] It may appear that this analysis holds only if there is a market for Counterparties who compete against each other for the Taxpayer's business, eliminating any possible rents. It is safe to assume that no such market exists, yet the analysis holds. The market is absent because not all potential Counterparties are the same. The Taxpayer trusts some a lot, others a little, and many not at all. The stronger the trust, the lower the probability of defection and risk-bearing loss. (Probability of defection affects a risk-bearing loss because if the probability is very small (or very large), the expected income and the certainty equivalent converge. *See* ROSEN, *supra* note 8, at 267-69.) Thus, the Taxpayer will choose the most trusted Counterparty as her relational tax planning partner. This suggests that the Counterparty is in a position to capture rents or quasi-rents, depending on the source of trust. (For a distinction between rents and quasi-rents, see, for example, Klein, Crawford & Alchian, *supra* note 74, at 298-99.) The Counterparty, it appears, is like a monopolist who can set the price that the Taxpayer must pay in order to elicit the Counterparty's cooperation, capturing the amount equal to the additional cost that the Taxpayer will incur if she has to deal with a less-trusted partner. Yet the monopoly here is probably bilateral. Intuitively, if the Counterparty is the Taxpayer's best friend, it is quite likely that the reverse is true as well. If the Counterparty "overplays" his hand, no other equally trusting Taxpayer is standing in the wings to replace the one who went elsewhere. If so, the Counterparty's bargaining power is limited, and he will deal with the Taxpayer even if the benefit captured by the Counterparty is diminishingly small.

The Counterparty's defection—unwelcome as it is—will have a silver lining. The Taxpayer will acquire new information about the Counterparty's trustworthiness. If the Taxpayer is fully rational and does not act strategically in a particular way, this additional information is a clear private benefit. Assume that the two transactors have developed a moderate level of trust (say, equal to 10 on some 100-point reliability scale). Relational tax planning forces the Taxpayer to place significant reliance on the Counterparty (say, equal to 50). If the Counterparty defects, all that the Taxpayer learns is that she cannot trust the Counterparty to that extent. This is useful information in itself, and it has no effect on the cooperation in the 1 to 10 range. Of course, the Taxpayer also incurs a loss L_C, but that loss was fully taken into account ex ante.

What if relational tax planning involves a modest reliance (say, of 8) and the Counterparty defects anyway? This will happen only if the Counterparty's preferences changed or if he acquired new information.[155] As long as this change is not caused by relational tax planning—and there is no reason to assume that this will be a typical case—the Taxpayer would have been betrayed anyway.[156] The Counterparty would have defected the next time the Taxpayer relied on the Counterparty at the same level (of 8) in their non-tax-related informal dealings. The only consequence of defection during the relational tax planning episode is that the Taxpayer learned about the preference change sooner.

The Taxpayer may act strategically, however. For expositional simplicity, assume that she adopts the "tough guy" strategy and discontinues all informal cooperation with contractual partners who defect in any respect.[157] This strategy may be rational because it signals to

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[155] I assume that tax planning is viewed as similar enough to other informal interactions that the level of trust is the same in all these settings. For further discussion, see *infra* text accompanying notes 169-170.

[156] While a preference change is conceivable, predicting its timing, underlying reasons, and direction remains an extremely challenging task. *See, e.g.*, Robert E. Scott, *The Limits of Behavioral Theories of Law and Social Norms*, 86 VA. L. REV. 1603, 1605, 1633-37 (2000) (explaining why abandoning a basic assumption of the rational choice theory—that preferences are exogenous and stable—undermines the theory's capacity to generate testable hypotheses). Given the pervasive uncertainty surrounding preferences, there is no reason to assume that their change—if any—is caused by any specific event, especially one as minor as a relational tax planning episode.

[157] An even "tougher" strategy would be to break up the business relationship entirely upon any Counterparty defection. Needless to say, many intermediate strategies exist. For a much more detailed discussion of retaliatory threats, see SCHELLING, *supra* note 75, at 35-43.

the rest of the world that the cost of betraying the Taxpayer's trust is higher than average.[158] If the Counterparty defects during a relational tax planning episode, and if the two have an ongoing business relationship, gains from the existing informal cooperation will be eliminated—a clear private loss.

Yet this scenario is not particularly likely. A Taxpayer who adopts an extreme response to even minor defections will not be a part of many informal relationships.[159] At the same time, a Counterparty aware of the Taxpayer's strategy is less likely to defect. Moreover, a rational Taxpayer would take into account that the signal sent by a "tough guy" response will be neither clear nor necessarily strong. Parties rarely publicize their relational tax planning. It is also frequently tailored to idiosyncratic transactions between the parties. Even in an environment where reputation for reliability is important, the Taxpayer will have a hard time convincing others what exactly was wrong with the Counterparty's actions. If so, the "tough guy" response loses its bite. In some business environments, a general reputation for trustworthiness is not worth all that much.[160] There, again, excessive toughness makes little sense. In sum, a loss of existing cooperation on account of relational

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[158] *See, e.g.*, *id.* at 17-18 (explaining why abandoning narrow rationality may be a superior negotiating strategy); Avery Katz, *When Should an Offer Stick? The Economics of Promissory Estoppel in Preliminary Negotiations*, 105 YALE L.J. 1249, 1298 (1996) ("Parties who can establish a credible reputation for stubbornness, spite, or even irrationality will increase their bargaining power . . . .").

[159] Minor defections (deviations from contract terms or requests for their modifications) are an everyday occurrence in commercial relationships. The voluminous literature describing how businesspeople resolve their disputes without resorting to lawyers and legal arguments provides plenty of evidence that these (relatively minor) disputes arise all the time. *See, e.g.*, Lisa Bernstein, *Merchant Law in a Merchant Court: Rethinking the Code's Search for Immanent Business Norms*, 144 U. PA. L. REV. 1765, 1787-88 (1996); Russell J. Weintraub, *A Survey of Contract Practice and Policy*, 1992 WIS. L. REV. 1, 22 (reporting that on average only 17.1% of respondent firms never ask to modify their contracts, while over 40% ask to do so at least one to five times a year). Restraint in responding to a counterparty's defection is a winning strategy. In a prisoner's dilemma tournament, a disproportionate reaction to defections made "nice" but "unforgiving" strategies less successful than tit-for-tat, a strategy that punishes a defection by one—and only one—defection of its own. *See* ROBERT AXELROD, THE EVOLUTION OF COOPERATION 35-36 (1984).

[160] *See, e.g.*, M. Bensaou & Erin Anderson, *Buyer-Supplier Relations in Industrial Markets: When Do Buyers Risk Making Idiosyncratic Investments?*, 10 ORG. SCI. 460, 475-76 (1999) (finding that supplier reputation has no effect on the magnitude of relation-specific investments reflective of the level of trust in the buyer-supplier relationship); Uzzi, *supra* note 148, at 677-80 (noting that in the New York garment industry, general reputation for reliability plays very little role, while bilateral relationships are extremely valued).

tax planning is possible, but its overall magnitude does not appear to be especially high. Not all Counterparties will defect, not all Taxpayers will act strategically, not all strategically acting Taxpayers will discontinue informal cooperation to the same (large) extent, and some of those who do would have done so anyway.[161]

What follows from this analysis is somewhat counterintuitive. Taking into account *both* the cooperation and defection outcomes, the Taxpayer stands to derive a unique gain from relational tax planning. The Counterparty's cooperation strengthens the Taxpayer's trust, allowing the Taxpayer to save on transaction costs in her future dealings with the Counterparty. The Counterparty's defection reveals new information about his trustworthiness. While it also imposes a loss on the Taxpayer, that loss is fully incorporated into the deal between the two parties ex ante (as the expected counterparty loss $\alpha_C \times L_C$), so it does not affect the marginal incentives of relational tax planners. The net effect of reduced transaction costs and new information is a reduced private cost of future informal contracting. I will call this net benefit to the Taxpayer the *cooperation gain* (*CG*).[162]

Yet something appears amiss. If the Taxpayer and the Counterparty stand to capture the cooperation gain from relational tax planning, why have they not captured this benefit already? What prevents contractors from optimizing the level of trust without any tax considerations involved? Is there a *unique* trust-enhancing effect of incurring counterparty risk?

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[161] If the Taxpayer responds irrationally, all bets are off. The most intuitive reaction is revenge and loss of the existing benefits of informal cooperation. But an irrational Taxpayer may draw exactly the opposite conclusion. She may decide, for example, that once the Counterparty betrayed her at a reliance level of 50, he is *less* likely to do so again. Predicting reactions of irrational individuals is impossible, which, no doubt, is why economics largely shies away from doing so.

[162] The Counterparty is also likely to benefit from the Taxpayer's decision to engage in relational tax planning, although the Counterparty's gain is likely to be much smaller. The Taxpayer's decision to rely on the Counterparty reveals the Taxpayer's *trust*. But the characteristic that signals reliability and leads to transaction cost savings is *trustworthiness*. The Counterparty learns nothing about it from the Taxpayer's trusting behavior, so he derives no direct benefit. Scholars have argued, however, that trust building takes place through reciprocal acts of trusting. *See* sources cited *supra* notes 137, 149. To the extent the Taxpayer's decision to rely on the Counterparty facilitates the Counterparty's decision to respond in kind, the Taxpayer's reliance indirectly facilitates trust building. Because this effect is more remote than that considered in the text, I will ignore it in the remainder of the discussion. This does not change the analysis. One can simply think of the cooperation gain as being slightly larger than otherwise to reflect the Counterparty's share.

To begin with, it is quite clear that the current level of trust between the vast majority of transactors can be increased. The mere presence of extensive formal contracts (tax- and non-tax-motivated) is the best evidence that most business relationships fall far short of the absolute trust benchmark.[163] Furthermore, the contractors' goal is not to maximize their trust, but to minimize total contracting costs.[164] In pursuing it, they take full advantage of contract law to limit opportunism and expand the self-enforcing range of their relationships by combining formal and informal enforcement.[165] This strategy—while perfectly rational—may well prevent contractors from pursuing trust-enhancing steps in designing their agreements.[166]

Fortunately for contracting parties, contract design—and specifically, the allocation of certain contractual rights and obligations to the informal realm—is hardly the only means of trust building. It is common knowledge that many commercial actors routinely deviate from the terms of their written agreements.[167] Most of these deviations are relatively minor, to be sure, but they allow the parties to strengthen their trust without affecting the overall structure of the contract.[168]

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[163] Formal contracting is expensive, yet the parties incur its cost because trust-based reliance is even more costly at the margin. With total trust, reliance would be costless and no formal contracts would exist.

[164] *See* Klein, *Why Hold-Ups Occur*, *supra* note 74, at 459 n.22 ("[C]ontract terms are set to minimize real costs (and not hold-ups).").

[165] *See id.* at 449-50.

[166] Strong support for this suggestion comes from the story told by Thomas Palay, discussed in detail below. *See infra* text accompanying notes 182-195. Palay documented an extraordinary level of cooperation achieved by some shippers and rail carriers who were forced to avoid extremely restrictive regulations imposed under the Interstate Commerce Act. As soon as the rail industry was deregulated, however, shippers and carriers who had been doing business without any formal documentation started documenting (some of) their dealings. Thus, even for the parties that had already reached a very high level of trust, it was cheaper to formalize some of their contractual relationships, putting less pressure on informal enforcement.

[167] For a summary of the literature, see Raskolnikov, *The Cost of Norms*, *supra* note 6, at 604-05.

[168] Lisa Bernstein and Robert Scott have each argued that contractors have good reasons to deviate from their formal agreements. *See* Bernstein, *supra* note 159, at 1796-98 (positing that contractors follow "relationship-preserving norms" to incorporate observable but unverifiable information, adapt to different stages in their relationship, simplify written contracts, and so on); Robert E. Scott, *A Relational Theory of Default Rules for Commercial Contracts*, 19 J. LEGAL STUD. 597, 613 (1990) (arguing that parties follow a more flexible set of rules for informal enforcement in order to overcome "the inherent limitations of the legal enforcement mechanism"). In fact, Bernstein observed that contractors will not strictly follow the letter of their contracts "*as*

Another familiar example is businesspeople's penchant for developing social connections. Personal interactions give transactors yet another venue to engage in trust building. Embedding business dealings into social networks adds to the range of penalties faced by defectors, making defections less likely. Thus, like minor deviations from written terms, social relationships are both separate from contract design (so they do not interfere with the contractors' main objective of minimizing total contracting costs) and related to contractual relationships (so that establishing social ties has a beneficial spillover effect on business cooperation).

Add regulatory avoidance to the list. This is yet another setting that allows transactors to demonstrate their trustworthiness without interfering with contract design. In addition, and similarly to social interactions, cooperative regulatory avoidance introduces a new type of penalty for defection. If both parties use each other's "services" to reduce their tax liabilities, a betrayed Taxpayer may tip off the regulator about the Counterparty's earlier aggressive tax positions.[169] Moreover, regulatory avoidance is even more closely related to commercial dealings than social interactions are because it is so clearly profit driven. Thus, because it is qualitatively different from other trust-enhancing strategies, relational regulatory avoidance may indeed have no substitutes.[170]

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long as they continue to trust one another and/or value potential future dealings." Bernstein, *supra* note 159, at 1796 (emphasis added). My suggestion is that parties do this *in order* to continue to develop their mutual trust, or, in Schelling's words, to create a "tradition of trust." SCHELLING, *supra* note 75, at 45.

[169] The Taxpayer will have no incentive to describe the very strategy where she was betrayed because in that case the Taxpayer is the one relying on relational tax planning.

[170] An alternative hypothesis is that once a Taxpayer requests Counterparty's assistance in skirting the tax rules, the Counterparty will view the Taxpayer as a *less* reliable business partner. *See* Eric A. Posner, *Law and Social Norms: The Case of Tax Compliance*, 86 VA. L. REV. 1781, 1789-90 (2000). For a rebuttal, see Russell Hardin, *Law and Social Norms in the Large*, 86 VA. L. REV. 1821, 1822-24 (2000). Hardin's view seems more persuasive. It is also supported by empirical data. Moreover, in contrast with Posner's model, which focuses on taxpayers who fail to comply with tax law, some relational tax planning strategies are almost certainly legal. After all, numerous relational tax planners won in court.

Another distinctive trust-building benefit of relational tax planning is that it may produce a nonreplicable combination of benefits and payoffs. The private benefit at stake—the tax savings—is an artificial gain produced by a regulatory regime. As long as costs and benefits of informal business-related cooperation do not vary continuously (and there is no reason to expect that they always do), relational tax planning may provide a cost-benefit combination that is not available to the parties otherwise. To take just one example, the net tax benefit may simply be larger than any net private gain

In addition, in some settings a tax benefit may tip the scale in favor of cooperation. Generally, whenever the expected non-tax-related gain from cooperation falls short of the expected cost of the counterparty defection, relational contracting fizzles. But if the transaction also gives rise to a tax benefit that exceeds this shortfall, cooperation becomes worthwhile. Tax savings, that is, may be just what the Taxpayer needs to take a plunge. For all these reasons, relational tax planning may play a crucial and unique role in the creation—and significant expansion—of cooperative relationships.

3. Additional Private Costs of Relational Tax Planning

Similarly to those who incur market and business risks, relational tax planners face a risk-bearing loss (RBL_C) and the expected tax liability ($\beta_C \times T$). In contrast with market- and business-risk-bearing taxpayers, relational tax planners face a unique complication. Contract scholars have long recognized that strategic behavior and asymmetric information give rise to two different types of costs. First, contractors consume resources directly. They hire lawyers, search for information that is known to the other side, delay efficient investments, and so on.[171] These are the familiar generic transaction costs. In addition, parties occasionally fail to reach agreements that would have made both sides better off.[172] They leave gains from trade on the table because they cannot overcome bargaining problems. Sometimes, a bargaining failure occurs after a negotiation has begun. On other occasions, a mere anticipation of a bargaining failure prevents a negotiation from ever taking place.

For a contract theorist, the distinction between these two types of costs is unimportant—both reduce the efficiency of private contracting. But for our purposes, the distinction is critical. Challenges of opportunistic bargaining are encountered only by relational tax planners. Taxpayers who face market and business risks avoid these problems entirely because they have no one to bargain with. The cost of failing (due to imperfect bargaining) to capture some of the private

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that would arise from non-tax-motivated informal cooperation. More generally, the tax planning benefit will just be different.

[171] *See* CASE STUDIES IN CONTRACTING AND ORGANIZATION, *supra* note 94, at 7; Williamson, *Transaction-Cost Economics*, *supra* note 75, at 242 (referring to "costly haggling").

[172] *See* CASE STUDIES IN CONTRACTING AND ORGANIZATION, *supra* note 94, at 7; Williamson, *Transaction-Cost Economics*, *supra* note 75, at 242 (referring to "efficient adaptations" that are not pursued due to strategic bargaining problems).

gains available to relational tax planners is a unique attribute of counterparty risk. I will call it the *bargaining cost* (*BC*).[173] We can finally summarize the total private cost of incurring counterparty risk:

$$PC_C = RBL_C + \beta_C \times T + BC - CG$$

In sum, the cooperation gain makes accepting counterparty risk relatively cheaper, while the bargaining cost makes it relatively more expensive than incurring market risk.

4. Social Costs and Benefits of Relational Tax Planning

As with other types of uncertainty, risk-bearing losses accompanying counterparty risk enter both the private and social cost calculations. Whether the cooperation gain and the bargaining cost do the same is more complicated. But before addressing these complexities, it is worth pointing out something that is fairly clear. The enforcement costs of imposing counterparty risk (EC_C) are significantly higher than EC_M and EC_B. This is because defining, finding, and prosecuting relational tax planning is particularly difficult, as discussed in Part III. For the same reason, the expected tax liability of counterparty risk ($\beta_C \times T$) is smaller than expected tax liabilities arising from market and business risks.

The manner in which the cooperation gain enters the social cost equation depends on the nature of transactions between the Taxpayer and the Counterparty other than the one generating the tax savings. If all other transactions are tax avoidance (or, worse yet, evasion), the enhanced trust makes the two parties better "partners in crime."[174] The (private) cooperation gain reduces social welfare.[175] If, on the other hand, all other interactions are not tax motivated, the cooperation gain produces a true social surplus because efficient behavior is

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[173] For a similar use of the term, see R.H. COASE, THE FIRM, THE MARKET, AND THE LAW 6 (1988).

[174] In addition, cooperation strengthened by relational tax planning may lead to more avoidance of non-tax regulatory regimes. The magnitude of such carryover effect need not be large, however. There is no clear evidence, for instance, that the U.S. manufacturers who formed successful export cartels also colluded to fix prices in domestic markets, even though this kind of carryover is much easier (one would think) than the one just discussed, and even though enforcement in this area has not been particularly strong. *See* Andrew R. Dick, *When Are Cartels Stable Contracts?*, 39 J.L. & ECON. 241, 247-48 (1996) [hereinafter Dick, *Stable Contracts*].

[175] That is, the cooperation gain should be *added* to other costs in the social cost equation.

facilitated by stronger trust.[176] If other interactions involve some of both, it is unclear whether the cooperation gain is a social cost or social benefit. What is the more likely outcome?

No doubt, the "partners in crime" scenario is a distinct possibility. Perhaps it is the first thing that comes to mind. And it is often true. Is it not crystal clear that the (private) cooperation gain is a significant social cost?

Not necessarily. Overwhelming evidence suggests that informal commitments are integral to many (perhaps most) business relationships. While this is certainly true of small entrepreneurs who rely on unenforceable promises of their local suppliers and customers,[177] even large companies and sophisticated transactors enter into relational contracts all the time.[178] Studies of these interactions demonstrate convincingly that combining formal and informal enforcement increases the value of contractual relationships, benefiting the specific contractors and the society as a whole.[179] Stronger trust reduces the transaction costs of relational contracting, magnifying these socially desirable effects.

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[176] In this case, the cooperation gain should be *subtracted* from other costs in the social cost equation.

[177] *See, e.g.*, James A. Wilson, *Adaptation to Uncertainty and Small Numbers Exchange: The New England Fresh Fish Market*, 11 BELL J. ECON. 491 (1980) (a study of fresh water fishermen); Comment, *The Statute of Frauds and the Business Community: A Re-Appraisal in Light of Prevailing Practices*, 66 YALE L.J. 1038 (1957) (a study of Connecticut manufacturers).

[178] *See, e.g.*, MARK CAREY ET AL., BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, THE ECONOMICS OF THE PRIVATE PLACEMENT MARKET, 4-5 (1993) (a study of the private placement debt market); Scott E. Masten & Edward A. Snyder, United States Versus United Shoe Machinery Corporation*: On the Merits*, 36 J.L. & ECON. 33, 56-64 (1993) (a study of the shoe-making machine manufacturers and users); Weintraub, *supra* note 159 (a study of a diverse sample of U.S. companies).

[179] Relational contracting allows parties to better respond to uncertainty and information asymmetries, *see* Simon Deakin et al., *"Trust" or Law? Towards an Integrated Theory of Contractual Relations Between Firms*, 21 J.L. SOC'Y 329, 333 (1994); act upon information that is observable (i.e., possible and worthwhile for transactors to obtain) but not verifiable (i.e., not worthwhile for them to prove to a neutral arbiter in the event of a dispute), *see* Bernstein, *supra* note 159, at 1791-92; Robert E. Scott, *The Case for Formalism in Relational Contract*, 94 NW. U. L. REV. 847, 862 (2000); enforce interior contractual provisions whose violation, while costly, is not harmful enough to justify bringing a law suit, *see* Lisa Bernstein, *Private Commercial Law in the Cotton Industry: Creating Cooperation Through Rules, Norms, and Institutions*, 99 MICH. L. REV. 1724, 1761 (2001); David Charny, *Nonlegal Sanctions in Commercial Relationships*, 104 HARV. L. REV. 373, 394-95 (1990); and more broadly, expand the self-enforcing range of their contractual relationships, *see* Klein, *Why Hold-ups Occur*, *supra* note 74, at 455-56.

But what does this have to do with relational tax planning? Is there any reason to think that extra trust generated in the process of reducing one's taxes carries over to other, non-tax-related aspects of a commercial relationship? Admittedly, evidence of such a spillover effect is limited and anecdotal. Yet casual empiricism may be the best we can do in this area. I suspect that no database contains detailed quantifiable evidence of informal regulatory avoidance, so econometric analysis is likely to be out of the question.[180] Efforts to conduct case studies are constrained by the subjects' reluctance to divulge information about tacit understandings that may come close to violating legal rules.[181] Recognizing these severe limitations, I draw on the following examples not to prove the existence of the trust-enhancing aspect of relational tax planning, but to suggest its plausibility.

Thomas Palay made what appears to be the single largest contribution to our understanding of the cooperation effects of regulatory avoidance. In a series of detailed interviews, he learned how rail-freight carriers (major railroads) and shippers (large manufacturing companies) "altered" the regulatory regime established by the Interstate Commerce Commission (ICC).[182] Whether because Palay assured his subjects of complete confidentiality,[183] because he managed to talk to businesspeople without getting the public affairs offices in-

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[180] Only when informal cooperation has macroeconomic effects (such as price changes for particular goods or services) can it be inferred based on econometric analysis. *See, e.g.*, Gareth R. Jones & Michael W. Oustay, *Interorganizational Coordination in the Airline Industry, 1925–1938: A Transaction Cost Approach*, 14 J. MGMT. 529, 535 (1988) (inferring informal cooperation from the differences between the starting and final prices in airmail route auctions).

[181] *See* Thomas M. Palay, *Comparative Institutional Economics: The Governance of Rail Freight Contracting*, 13 J. LEGAL STUD. 265, 266-67 (1984) [hereinafter Palay, *Rail Freight Contracting*] (reporting the difficulties of obtaining information about informal cooperation designed to escape the constraints of the Interstate Commerce Act). Because commercial actors are much more forthcoming about violating the terms of their private agreements, this phenomenon is much better understood. *See, e.g.*, Bernstein, *supra* note 159, at 1799 (explaining that cotton traders routinely violate the terms of their contracts governing the use of weights); Stewart Macaulay, *Non-Contractual Relations in Business: A Preliminary Study*, 28 AM. SOC. REV. 55, 61 (1963) (reporting that entrepreneurs view contract cancellations not as contractual breaches, but as an ordinary part of buyer-seller relationships); Sally Falk Moore, *Law and Social Change: The Semi-Autonomous Social Field as an Appropriate Subject of Study*, 7 LAW & SOC'Y REV. 719, 725 (1973) (describing how jobbers and union representatives "regularly" accede to violations of the union contract).

[182] *See* Thomas M. Palay, *Avoiding Regulatory Constraints: Contracting Safeguards and the Role of Informal Agreements*, 1 J.L. ECON. & ORG. 155, 156-57 (1985) [hereinafter Palay, *Avoiding Constraints*].

[183] *See id.* at 156 n.2.

volved,[184] or because the regulatory regime that the companies learned to skirt was about to fall in any case,[185] the interviewees provided Palay with a surprisingly detailed account of their regulatory avoidance.

The ICC regulations faced by Palay's subjects were extremely restrictive at the time. They prohibited shippers and carriers from entering into long-term contracts, establishing price incentives, setting service standards, or making volume commitments.[186] For some manufacturers and railroads, it was simply impossible to conduct business in full compliance with the ICC rules.[187] These transactors entered into informal, mostly oral, and clearly unenforceable agreements that avoided some (and often most) of the enumerated limitations.[188] Once the parties were forced to rely on each other to get around the regulations, they developed mutual trust, achieving a remarkable degree of cooperation. They invested millions of dollars based solely on oral assurances.[189] One auto manufacturer kept its promise and paid the rail carrier over $1 million without any legal obligation to do so.[190] As importantly, strong trust built in interactions such as these extended to the aspects of relationships that had nothing to do with regulatory avoidance. For instance, shippers and carriers exchanged highly proprietary business projections, routinely

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[184] In fact, the subjects' willingness to talk without involving the public affairs department was one of Palay's selection criteria. *See id.*

[185] Palay conducted his interviews between October and December of 1979. *Id.* Deregulation was very much in the air at that time. The airline industry had already been deregulated in 1978. *See* Airline Deregulation Act of 1978, Pub. L. No. 95-504, 92 Stat. 1705. Congress was considering an influential report describing the severe problems of the rail freight industry under the existing regulatory scheme. *See* James M. Macdonald & Linda C. Cavalluzzo, *Railroad Deregulation: Pricing Reforms, Shipper Responses, and the Effects on Labor*, 50 INDUS. & LAB. REL. REV. 80, 80 (1996). The ICC was reversing its restrictive regulatory stands. *See* Palay, *Avoiding Constraints*, *supra* note 182, at 158 n.4. The Staggers Act that deregulated the railroad industry was adopted in 1980, and it was likely being actively discussed in late 1979. *See* Staggers Rail Act of 1980, Pub. L. No. 96-448, 94 Stat. 1895.

[186] *See* Palay, *Avoiding Constraints*, *supra* note 182, at 157-58, 162.

[187] This was the case when one of the parties had to make a large transaction-specific investment, such as when a carrier needed to construct auto racks that could carry only the cars made by a particular manufacturer, *see id.* at 161, or when a shipper had to build a plant that could be serviced only by a specific railroad, *see id.* at 160.

[188] *See* Palay, *Rail Freight Contracting*, *supra* note 181, at 276-77. "[These] informal contracts provided a vehicle for adjusting contract prices or values even where the [Interstate Commerce Act] prohibited such practices." Palay, *Avoiding Constraints*, *supra* note 182, at 168.

[189] Palay, *Rail Freight Contracting*, *supra* note 181, at 277.

[190] *Id.* at 276.

agreed to adjust their informal understandings, and made unilateral (and costly) investments to accommodate the counterparty's idiosyncratic preferences.[191]

Can we be sure that it was regulatory avoidance that facilitated broader cooperation and not vice versa?[192] Two observations suggest (while by no means prove) that this was the case. First, the ICC regulations presented no problem for some shippers and carriers.[193] These transactors did not need to engage in regulatory avoidance. They also did not appear to develop broader trust-based relationships similar to those built by shippers and carriers for whom escaping the ICC regime was a necessity. Thus, there is no reason to conclude that it was the general preference of all shippers and carriers to do business informally. Quite the contrary, extensive relational contracting emerged only alongside regulatory avoidance. Second, once the industry was deregulated, many provisions that were part of tacit understandings became incorporated into express written agreements.[194] The earlier custom of keeping these understandings informal, therefore, was not caused by these parties' general dislike of all formalities. Rather, it was the need to circumvent the ICC regulations that led to informal contracting.[195] The resulting trust benefited the entire relationship.

While Palay's story is the most detailed account of how regulatory avoidance facilitated broader commercial cooperation, other examples suggest that the two may be mutually reinforcing. For instance, when commercial banks and municipal bond dealers participating in the repo market encountered a regulatory problem, they responded by switching from formal to informal enforcement for the repurchase part of the trade.[196] Perhaps there was already some level of trust

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[191] *Id.* at 277, 282, 285-86.

[192] Causation could run in the opposite direction: because these transactors had a strong cooperative relationship, they were able to successfully "alter" the unfavorable regulatory regime once the need to do so arose.

[193] *See* Palay, *Avoiding Constraints*, *supra* note 182, at 159-60 (providing examples of a shipper that could use any of three rail carriers and a carrier whose cars could be used to transport bulk items of several shippers).

[194] *See* Laurence T. Phillips, *Contractual Relationships in the Deregulated Transportation Marketplace*, 34 J.L. & ECON. 535, 544-45, 558 (1991) (referring to thousands of long-term contracts filed with the ICC after the 1980 deregulation that contain price escalators, individualized rates, and service level guarantees).

[195] This appears to have been Palay's view as well. *See* Palay, *Avoiding Constraints*, *supra* note 182, at 167-68.

[196] *See* Raskolnikov, *The Cost of Norms*, *supra* note 6, at 628-29.

among the market participants, although it could hardly be high given that the market was just developing.[197] On the other hand, informal cooperation needed to solve the regulatory problem likely contributed to the fact that the money market has been described for decades as an environment "in which people say, 'My word is my bond,' and mean it."[198]

Modern financial markets exhibit similar features. Elsewhere, I described how financial institutions and hedge funds use contractual norms to produce considerable tax savings.[199] Yet the same transactors rely on informal cooperation to capture the benefits of financial innovation that are completely unrelated to tax.[200] In fact, they have done so for years.[201] A similar story may be told about other commercial environments.[202]

The emerging picture, therefore, is more complex than it might have initially appeared. Clearly, relational tax planning may produce

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[197] The repo market developed in the 1910s and 1920s. *See* STIGUM, *supra* note 81, at 81-87. The regulatory problem arose in 1922. *See* First Nat'l Bank in Wichita v. Comm'r, 19 B.T.A. 744, 745 (1930).

[198] STIGUM, *supra* note 81, at 218; *see also id.* at 3-4, 193-96 (explaining that for decades, the repo market was highly informal and was an integral part of the interconnected money market, which strongly valued trustworthiness).

[199] *See* Raskolnikov, *The Cost of Norms*, *supra* note 6, at 616-18.

[200] *See id.* at 622-25.

[201] *See id.* at 680.

[202] The motion picture distribution industry is one example. From its early days, film distributors and exhibitors supplemented their written agreements with an implicit understanding—a combination that maximized the surplus shared by the parties. *See* Roy W. Kenney & Benjamin Klein, *How Block Booking Facilitated Self-Enforcing Film Contracts*, 43 J.L. & ECON. 427, 430-32 (2000) [hereinafter Kenney & Klein, *Self-Enforcing Film Contracts*] (describing an informal understanding among motion picture distributors and exhibitors that allowed exhibitors to replace underperforming films). When the Department of Justice intervened and forced the distributors to accept new ways of marketing their movies, little changed in practice. Industry participants defied the unwanted requirements through a different kind of informal cooperation. *See* Roy W. Kenney & Benjamin Klein, *The Economics of Block Booking*, 26 J.L. & ECON. 497, 519 (1983) (describing how distributors almost never attended showings even though this was a valuable right conferred on them by the consent decree negotiated by the Justice Department). Even after the Supreme Court fundamentally changed the formal rights and obligations of the industry participants, they developed yet another unenforceable norm that allowed the business to continue largely unchanged. *See* Kenney & Klein, *Self-Enforcing Film Contracts*, *supra*, at 433-34 (describing the legal changes and the new informal understanding, and arguing that, as a result of adopting the new custom, film license fees as a percentage of admission revenue remained largely unchanged). This new implicit understanding has survived for at least five decades. *See id.* at 434. Thus, distributors and exhibitors succeeded in fostering informal cooperation whether it made sense based on the business realities or was needed to circumvent legal constraints.

social harm by facilitating more of the same. On the other hand, socially beneficial informal cooperation is pervasive, and some evidence suggests that it may be generated—or reinforced—by regulatory avoidance. On balance, it is far from clear whether the total economic loss from socially harmful relational tax planning exceeds the overall welfare gain from the socially beneficial relational contracting that this tax planning facilitates. In light of this uncertainty, I will assume that socially positive and negative effects of relational tax planning roughly offset one another. If so, the cooperation gain does not enter the social cost calculus.

Taking the cooperation gain out of the equation helps evaluate the social welfare effect of the bargaining cost. This cost reflects a possible failure of strategic negotiations. When this failure occurs, the Taxpayer and the Counterparty do not engage in relational tax planning even though its private benefit exceeds its private cost. Whenever this happens, society benefits because deadweight loss of tax planning does not materialize.[203] No risk-bearing losses are incurred; no generic transaction costs are wasted. To be sure, the cooperation gain also disappears. But because it is excluded from the social cost calculation, this makes no difference. Thus, society loses nothing when imperfect bargaining precludes relational tax planning. In contrast to similar losses incurred by non-tax-motivated commercial actors, the bargaining cost is a private, but not a social, loss. Therefore, the social cost of incurring counterparty risk may be expressed as:

$$SC_C = RBL_C + EC_C$$

D. *Multilateral Counterparty Risk*

As with market, business, and counterparty risks, multilateral risk stops some taxpayers from engaging in wasteful tax planning and imposes risk-bearing losses on those who remain undeterred. Like counterparty risk (but not market risk), multilateral risk produces the cooperation gain and bargaining cost. Unlike any other type of risk, multilateral risk gives rise to an externality. This externality has two distinct components, and it makes sense to consider them separately.

First, when interactions take place in a norm environment, they are observed by other group members. Each act of Taxpayer/Counterparty

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[203] The magnitude of these losses, it is worth remembering, is not equal to the size of the tax savings. For a discussion, see Louis Kaplow, *How Tax Complexity and Enforcement Affect the Equity and Efficiency of the Income Tax*, 49 NAT'L TAX J. 135, 139-40 (1996).

cooperation demonstrates their commitment to the specific cooperative norm. As discussed above, this reaffirmation of commitment enhances the trust between the transactors involved. In addition—and this is a unique feature of multilateral risk—the demonstrated commitment to a norm reinforces that norm. A stronger norm makes relying on it less risky for all members of the norm environment. A defection by the Counterparty has the opposite effect.[204]

If the transaction is a repo, future repurchases by all repo market participants are more assured each time the two parties follow the fixed-price repurchase norm. Similarly, all future charitable donations followed by the specific use of the proceeds by the charities are less risky each time a donor relies on a charity and the latter cooperates. The two members of a given norm environment who abide by a particular norm in their dyadic interaction do not take this benefit to others into account, but policymakers certainly should. I will refer to it as the *specific externality* because it is specific to the cooperative norm used in the exchange that reinforced it.[205]

Another externality produced by the Taxpayer/Counterparty interaction is less direct but not less important. To the extent that the members of a given group are engaged in interactions *other than* the one involved in the particular Taxpayer/Counterparty exchange, stronger trust within the group makes all those interactions go more smoothly as well. Enhanced trust, in short, is not transaction specific. This is the *general externality* produced by imposition of multilateral risk.

For instance, if bond dealers who enter into repos with financial institutions also borrow from them, use their research services, enter into derivative trades, and so on, all these interactions become easier (transaction costs decrease) if the specific repo trade reinforces the level of confidence that in this environment the parties will not de-

[204] In a bilateral context, cooperation and defection have similar effects on the general level of trust in a business environment. However, the link between the actions of specific transactors and the general atmosphere is much weaker in the absence of norms. Information is not disseminated nearly as easily and expectations about specific patterns of behavior are not nearly as well set. Therefore, I have ignored the externality in a bilateral setting.

[205] Note that unlike the cooperation gain, the specific externality arises even if a bilateral interaction is a one-shot deal. If a particular donor plans no further gifts to a given charity, she may well make future gifts to other charities. At the same time, the particular charity will receive gifts from other donors. All of these interactions will be made easier (less risky for the donor-Taxpayer) if the charity receiving the gift in question cooperates. Thus, as long as there is a group sharing an informal norm, *any* interaction in which group members follow this norm strengthens it, yielding the specific externality.

fect.[206] The same is true of family members who co-own a family business, and also jointly manage investments, serve as grantors and trustees of various trusts, and engage in other kinds of business relationships.

Both externalities may conceivably strengthen or weaken cooperation. Almost certainly, the former effect prevails. The very existence of a norm environment means that most of its members cooperate most of the time. The fact that the Counterparty remains a member of this environment strongly suggests that, at the very least, he cooperates (much) more often than not. Thus, it is safe to assume that on balance, both externalities reflect additional cooperation.

By definition, externalities do not affect *private* benefits and costs.[207] What are their likely *social* welfare effects? The specific externality facilitates tax avoidance. Elsewhere I have introduced the term *tax-driven norm*, defining it as "an informal customary practice adopted (or persisting) in order to obtain a tax benefit by forgoing formalization of a particular understanding."[208] Tax-driven norms are especially inefficient. They produce deadweight losses typical of any tax planning and, in addition, introduce allocative distortions because economic activity shifts toward environments with many tax-driven norms.[209] A Taxpayer who enters into a tax-motivated exchange with a Counterparty and incurs multilateral risk is relying on a tax-driven norm. The specific externality makes tax-driven norms stronger. In the first approximation, a stronger norm leads to more tax-motivated transactions, but a cost of each transaction declines (due to lower risk and lower risk-bearing loss). It is difficult to conclude as a general matter whether a stronger tax-driven norm amounts to a smaller or larger welfare loss.[210]

Evaluating the general externality is also challenging. The analysis turns on the character of norms other than the one used in the transaction that gives rise to this externality. Not all norms are tax driven. Some have no tax effects at all—they are tax neutral.[211] Others do have tax consequences, but the reasons for the norms' exis-

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[206] In fact, this appears to be exactly how the repo norm affected the money market in general. *See supra* text accompanying note 198.

[207] *See* ROSEN, *supra* note 8, at 81-82.

[208] Raskolnikov, *The Cost of Norms*, *supra* note 6, at 613.

[209] *See id.* at 643-45.

[210] Whether the resulting total deadweight loss is larger or smaller depends on the elasticity of taxpayers' response to the cost of relational tax planning.

[211] *See* Raskolnikov, *The Cost of Norms*, *supra* note 6, at 629.

tence have nothing to do with tax planning. I have called these norms *tax relevant*.[212] Tax-neutral norms produce no tax-related deadweight losses and have many welfare-enhancing effects.[213] Tax-relevant norms combine some of the inefficiencies of tax-driven norms with some of the efficiencies of tax-neutral ones.[214]

Considerable empirical evidence suggests that norm environments typically contain numerous individual norms.[215] If most norms in a given environment are tax neutral, strengthening them is welfare enhancing, and the general externality is positive. In contrast, if the norm environment consists largely of tax-driven norms, the general externality may well be negative. In intermediate cases (and in cases where most norms are tax relevant), the sign of this externality is uncertain.

What can we take away from this discussion of multilateral risk? Tax-driven norms are yet another distinctive aspect of relational tax planning. Evaluating their effect on social welfare, however, is difficult. Until future research provides us with more information, it seems misguided to insist that taxpayers' acceptance of multilateral risk gives rise to a significant overall social cost or benefit. Case-by-case evaluations may be more informative, as discussed in Part VI.

E. *Comparing Risks*

We can now evaluate different risks relative to each other. It is fairly easy to compare market and business risks. Because there is no reason to assume that the respective expected tax liabilities and enforcement costs differ systematically and considerably, we may eliminate them from equations. The simplified private and social costs are as follows:

	Market Risk	**Business Risk**
Private Cost	RBL_M	$RBL_B + \alpha_B \times L_B$
Social Cost	RBL_M	RBL_B

[212] *See id.* at 622-25.
[213] *See id.* at 605-07.
[214] Tax-relevant norms are less inefficient than tax-driven ones because they are not tax motivated. While they produce allocative distortions, they are also likely to give rise to non-tax-related transaction cost savings typical of many non-tax-driven norms. For a more detailed discussion, see *id.* at 645-46.
[215] *See id.* at 673-74.

This comparison reveals a striking difference. Assume, first, that a rule imposing market risk is as efficient as an alternative rule that imposes business risk. This means that the respective social costs, and therefore, the risk-bearing losses, are the same.[216] It then follows that the business-risk-imposing rule is a stronger deterrent, that is, it forces a would-be tax planner to bear a higher private cost. The expected business loss ($\alpha_B \times L_B$) provides additional deterrence.[217] Or we can turn around and assume that the two rules are equal deterrents (impose equal private costs). If so, the rule imposing business risk is necessarily more efficient because the risk-bearing loss of business risk (and, therefore, its social cost) is certainly smaller than that of market risk.[218] In sum, business risk is a superior policy instrument compared to market risk. Equally efficient business risk is a stronger deterrent, and equally deterring business risk is more efficient.

Counterparty risk is more complex than market (and business) risk, and its components are more uncertain. The respective enforcement costs certainly differ (with EC_C being larger than EC_M). The same is true of the expected tax liabilities (with $\beta_C \times T$ being smaller than $\beta_M \times T$). Therefore, neither component can be eliminated for comparison purposes. The bargaining cost increases the private cost of counterparty risk compared to market risk, and the cooperation gain has the opposite effect. No general conclusions can be made in the abstract. These results are summarized in the table below:

	Market Risk	**Counterparty Risk**
Private Cost	$RBL_M + \beta_M \times T$	$RBL_C + \beta_C \times T + BC - CG$
Social Cost	$RBL_M + EC_M$	$RBL_C + EC_C$

Yet the above analysis of counterparty risk is far from pointless. Although the first-best comparison of market and counterparty risks that fully takes account of both private and social costs is impossible, we can make a second-best effort to compare risks of similar magnitude, as Part VI demonstrates. Even more can be learned about relative deterrent effects of counterparty risk incurred by different types of taxpayers and counterparties. Finally, a first-best comparison is impossible only if the current rules are taken as a given. Only under

[216] That is, $RBL_M = RBL_B$.

[217] If $RBL_M = RBL_B$, then $RBL_M < RBL_B + \alpha_B \times L_B$ (given that $\alpha_B \times L_B > 0$).

[218] If $RBL_M = RBL_B + \alpha_B \times L_B$, then $RBL_M > RBL_B$ (given that $\alpha_B \times L_B > 0$).

these rules, for instance, is EC_C necessarily higher than EC_M. An alternative system may change this relationship, not only enabling the comparison, but possibly demonstrating certain efficiency advantages of counterparty risk as well. Such an alternative regime is considered next.

V. ANTICIPATING RELATIONAL TAX PLANNING: A SWEEPING REFORM

A study of relational tax planning highlights considerable problems that arise when taxpayers substitute (low) counterparty risk for (government-calibrated) market risk. Yet, economic analysis suggests that counterparty risk may be a more or less attractive policy instrument, depending on the resolution of several uncertainties. If we could disentangle the issue of the risk's magnitude from the question of its type—if, for example, it were possible to deter tax planners equally well with either market or counterparty risk—the latter option may be preferable. This Part argues that it is indeed possible to create an alternative regime where most taxpayers incur counterparty risk. Deciding whether such a regime should, in fact, be adopted is more challenging.

A. *Incorporating Relational Tax Planning into Risk-Based Rules*

Exposure to market risk is inherent in buying and selling assets and in choosing a method of financing. No doubt this is why most risk-based rules are designed to subject taxpayers to market risk. If we view this connection between the specific kind of risk and the particular nature of the activity protected by a risk-based rule as furthering some fundamental goal of our tax system, the only appropriate response to relational tax planning is to impede it. If, however, as this Article suggests, market risk is merely a friction needed to deter tax-motivated behavior, there is no reason to assume that it is the only possible one. Rules designed to impose market risk have been ineffective in combating relational tax planning. It is worth considering whether changing the type of friction is a better response than defending the one we currently have. While back-somersaults are always a possibility, counterparty risk is the obvious alternative friction to explore.

How can counterparty risk become an adequate friction? Instead of resisting relational tax planning, the government may consider embracing it. Rather than designing rules on the assumption of no cooperation among taxpayers and then defending these rules in situations where cooperation exists, the government can accept the inevitable, so to speak. If aggressive taxpayers repeatedly (and successfully) circumvent risk-based rules by hidden cooperation, the government can assume that this will take place when it creates the rules in the first place.[219] For waiting-period provisions, this will simply mean longer waiting periods. Even if many/most taxpayers enter into wash sales with their friends and business partners (I do not suggest that they currently do), they can still be forced to bear a significant risk as a price of deducting a loss. All the government needs to do is extend the waiting period from thirty days to two, three, or even six months. Adjustments to other risk-based rules would be relatively straightforward as well.[220]

The friendly wash sale works only as long as the Wash Buyer resells the loss security for the same price as she paid to purchase it. Except by accident, the actual price at the time of repurchase will be different. Needless to say, the Wash Buyer is under no legal obligation to resell for the same price. The longer the waiting period, the larger the possible price fluctuation, the higher the risk of going forward with the friendly wash sale.[221]

This example provides a specific illustration of a general point. Whether the government expects taxpayers to assume counterparty or market risk, it may be possible to set the magnitude of either risk (roughly) the same, for instance, by adjusting the waiting periods depending on the type of risk that taxpayers are expected to incur. That is, the government may *recalibrate* its risk-based rules by assuming that taxpayers will engage in relational (rather than traditional) tax planning.

If the very idea of much longer waiting periods seems outlandish, consider some existing provisions. Most waiting periods are measured in days. Some, however, last years. For instance, the waiting period

[219] Note that this option is not available as a response to traditional tax planning. If taxpayers are allowed to hedge, they will eliminate the risk imposed by risk-based rules completely, making these rules nugatory. The effect will be particularly strong for financial assets because of a wide availability of hedging techniques.

[220] For instance, the constructive sale provision may be strengthened by switching to the so-called straddle standard, that is, by triggering a constructive sale if a taxpayer substantially diminishes (rather than eliminates substantially all of) her risk of loss and opportunity for gain from an appreciated security. The step transaction doctrine may be strengthened by collapsing the steps unless more uncertainty exists regarding the later steps when the earlier steps are taken (compared to the current rules).

[221] This is so because the price of the loss security in six months may be so high that the Wash Buyer may defect, betray the friendship, and refuse to resell the security to the Wash Seller for the original price.

imposed on a heartless taxpayer who transfers appreciated property to her dying relative hoping to receive it back as a bequest (and, therefore, with a "stepped-up" fair market value basis) is one full year.[222] An even longer waiting period applies to a transaction we have already considered: a full redemption of the Parent's interest in a family-controlled business. Congress decided to allow the Parent to treat this redemption as a tax-favorable stock sale after all, but only if the Parent agrees to wait for *ten years* before reacquiring any interest in the redeeming corporation![223] How can these draconian requirements be explained in light of a thirty-day wait needed to claim a wash sale loss and many similar rules?

No doubt, the answer is that Congress suspects that informal norms of family support reduce the real risk incurred by the Parent and the heartless taxpayer willing to use a dying relative to eliminate a taxable gain. It is quite clear that admonitions against implicit understandings will simply fail in a family setting. Just by virtue of being family members, taxpayers will convert market risk into counterparty (here, multilateral) risk and defeat the government's market-risk-imposing rules. The dramatic ten-year waiting period is an example of congressional use of the very approach suggested here: Congress assumed cooperation among close relatives and imposed a waiting period based on that assumption. Unlike most other risk-based provisions, these rules were designed to impose counterparty (rather than market) risk.

Applying the same approach more broadly will yield at least one significant benefit. Whether risk-based rules are designed with market or counterparty risk in mind, they remain vulnerable to end runs.[224] The response needed to foreclose these end runs is different, however. In order for the market-risk-imposing rules to work, they must be protected by two separate backstop provisions. First, they must be guarded against excessive risk reduction via formal contracts (hedging and, occasionally, diversification). Thus, a *traditional backstop* is needed to deter traditional tax planning. Second, these rules must deny tax benefits to those who enter into informal arrangements or understandings related to the risk-imposing transaction. This *relational back-*

[222] I.R.C. § 1014(e) (2000).

[223] More precisely, the Parent is allowed to maintain an interest in the redeeming company, but only as a creditor or if received by bequest or inheritance. *See id.* § 302(c)(2).

[224] The analysis for business risk is similar to that for market risk, and I omit it for brevity.

stop protects against relational tax planning.[225] The existing risk-based rules need both backstops. But the alternative counterparty-risk-imposing regime requires only the traditional one.[226] Because this regime is designed assuming taxpayers' reliance on implicit agreements, there is no reason to police their existence with the relational backstop.

A chance to eliminate the need to define, search for, evaluate, and prove the existence of tacit understandings is enticing. No matter how difficult it may be to take formal contracts into account (and these difficulties are painfully familiar[227]), doing so is much less costly than responding to equally varying and complex strategies that rely on informal arrangements.[228] Moreover, traditional backstops actually used today are significantly more effective than relational ones. The government has plenty of experience in dealing with formal hedging arrangements, even if with mixed success. The government's record of countering relational tax planning is much less impressive. In sum, the alternative approach will need only one type of backstop, and this backstop will be the more effective of the two already in place. Clearly, the alternative system will be less expensive to administer.

This is not to say that such a regime is unambiguously preferable to the status quo. To begin with, extending waiting periods (and increasing the amount of requisite risk by other means, such as a more demanding application of the step transaction doctrine) will not turn strangers into friends, it will merely expose them to larger risks. It is safe to assume that *some* taxpayers substitute counterparty risk for market risk today. Whether *most* do so is much less certain. If the rules are recalibrated based on the assumption that most taxpayers

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[225] That is, a relational backstop denies the tax benefit to those who comply with the letter of the law but have an informal understanding that reduces the intended degree of risk.

[226] This backstop will need to be expanded to incorporate not only enforceable contracts, but formal ownership structures as well. For instance, relational tax planning between two wholly owned subsidiaries should clearly not entitle either entity to claim any tax benefits.

[227] *See supra* text accompanying notes 15-16.

[228] It may appear that implicit agreements simply cannot replicate complex financial instruments used by taxpayers to hedge market risk. That much is true, but it proves little. To engage in relational tax planning, taxpayers need not abandon the realm of formal contracts entirely. They only need to remove a critical term from the enforceable (and observable) written agreement. Plenty of evidence suggests that taxpayers have successfully done this on many occasions even where the underlying formal contracts were quite complex. *See* Raskolnikov, *The Cost of Norms*, *supra* note 6, at 651-65.

will respond by engaging in relational tax planning and this assumption turns out to be wrong, these rules will end up subjecting taxpayers to vastly excessive amounts of risk. No enforcement cost savings will compensate for gross overdeterrence. To assess whether this is likely to occur, we need to consider more carefully how taxpayers currently plan around market-risk-imposing rules and how they are likely to adapt to the proposed change.

B. *Excessive Market Risk or More Cooperation?*

Taxpayers differ along many dimensions: wealth, intellect, appetite, and so on. The heterogeneity important for our purposes is the difference in taxpayers' willingness and ability to cooperate.

Let us divide all taxpayers into four categories: three types of tax planners and *innocent taxpayers*. Those in the last category (the analogy to tort law's innocent bystanders intended) engage in no tax planning, but end up being affected by risk-based rules nonetheless. For instance, a taxpayer who sells a security at a loss with no intention to repurchase it, but three weeks later has a true change of heart and decides to reacquire the security, is an innocent taxpayer. She did not sell to take a tax loss, but she will be unable to deduct it if she repurchases the loss security within the thirty-day waiting period. Innocent taxpayers are the unintended victims of risk-based rules.

The three categories of tax planners are *strong cooperators*, *weak cooperators*, and *loners*. The division is purely functional. Assume that (like many existing provisions) all market-risk-imposing rules have a relational backstop. This backstop applies only at some threshold of cooperation. Whatever that threshold is, strong cooperators can circumvent it.[229] Loners are at the opposite extreme: they trust no one and, therefore, are incapable of engaging in relational tax planning of

[229] For instance, the backstop may be relatively weak. It may be triggered only if taxpayers have a contract that is not legally binding only because it violates some formality (e.g., it lacks consideration or does not comply with the statute of frauds). Strong cooperators do not need to enter into such contracts to cooperate successfully. A more robust provision would deny a tax benefit if taxpayers have an explicit agreement, even though it is not specific enough to give rise to a contract. Strong cooperators can transact without reaching such explicit agreements. An even more far-reaching rule would apply to taxpayers who had any discussions about a particular transaction at all. Strong cooperators can successfully rely on each other without discussing specific deals. Thus, strong cooperators are beyond the reach of the relational backstop.

any kind. Weak cooperators are the rest of tax planners (probably the largest group).

How do all these individuals fare under the current risk-based rules? Loners bear the full brunt of the market-risk-imposing provisions. Additional prohibitions against implicit arrangements are of no relevance to them because they do not enter into any such arrangements anyway. These taxpayers are either deterred from tax-motivated transactions or they assume market risk and pay the full price that the government set for the tax benefits in question. For loners, market-risk-imposing rules work as intended.

Strong cooperators convert the precalibrated market risk into a much smaller counterparty risk and reduce their taxes significantly. They are grossly underdeterred.

Weak cooperators are the group affected by the relational backstop. They do cooperate in general, and they could have entered into some informal arrangements that, even though not legally binding, would have produced counterparty risk that is smaller than market risk imposed by the substantive provisions. However, these arrangements are too "strong"—they violate the backstop prohibition against implicit understandings and, therefore, they are not worth pursuing.[230] As a result, weak cooperators are in the same position as loners. In sum, the existing regime provides desired deterrence for loners and weak cooperators and underdeters strong cooperators. Only strong cooperators are cooperating.

Consider now what would happen if the government adopts the alternative approach and recalibrates risk-based rules assuming that taxpayers will engage in relational tax planning. The government would also repeal the relational backstop while retaining the traditional one, as well as keeping some of the existing "related party" presumptions.[231] These changes will affect taxpayers in all four categories.

Innocent taxpayers will clearly suffer. The alternative regime will "misfire" and impose a burden on these actors much more often.

[230] To simplify the discussion, I focus here only on legal issues. Another difference among taxpayers is their ability to hide aggressive positions. Incorporating that difference does not alter the analysis. Weak cooperators who are particularly good at hiding their informal understandings will simply be in the same position (and will act) as strong cooperators.

[231] *E.g.*, I.R.C. § 267(b) (2000); *id.* § 707(b). These rules will continue to be needed because even in the alternative regime taxpayers will bear no risk at all in some cases (such as where the Taxpayer controls the Counterparty), and too little risk in others (such as in transactions between parents and children).

Strong cooperators will continue to cooperate. Counterparty risk will still be smaller than market risk, so cooperation will continue to make sense. The amount of uncertainty borne by strong cooperators will change, however. It will now be sufficiently high to create a friction intended by the rule drafters.[232]

Loners will face a much larger market risk than they did before. The only way for these taxpayers to lower their risk will be by entering into risk-reducing contracts, that is, by hedging. The remaining traditional backstop will continue to foreclose this response. In all likelihood, the higher market risk will be so great that very few loners will accept it. Assuming the risk they bore before was optimal, loners will be now overdeterred.[233]

The new regime will change the behavior of weak cooperators as well. It will now make sense for them to enter into relatively strong (yet informal) arrangements. These agreements will not run afoul of the remaining backstop rule, and they will convert market risk into a lower counterparty risk. Thus, weak cooperators will start cooperating.

We can now compare how the two regimes affect various tax planners. Both appropriately deter two categories of taxpayers: loners and weak cooperators in the first regime; strong and weak cooperators in the second.[234] In both regimes, one category is not deterred as intended. In the first, strong cooperators are underdeterred; in the

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[232] This conclusion may be unduly optimistic. *See infra* text accompanying notes 237-238.

[233] Tax planning may be overdeterred not because (like a polluting widget-making factory) it is socially beneficial at a certain level, but because at some point the full social cost of deterring it (a cost that includes risk-bearing and other losses borne by those who are not deterred) combined with the cost imposed on innocent taxpayers exceeds the benefit from decreased deadweight losses of tax planning. For a detailed explanation of why setting expected penalties in excess of external harm produced by a particular conduct is inefficient, see, for example, Richard Craswell, *Deterrence and Damages: The Multiplier Principle and Its Alternatives*, 97 MICH. L. REV. 2185, 2195 (1999), and A. Mitchell Polinsky & Steven Shavell, *Punitive Damages: An Economic Analysis*, 111 HARV. L. REV. 869, 877-87 (1998). Perhaps because tax noncompliance is widely viewed as producing no social benefit whatsoever, tax enforcement literature has been largely unconcerned with the problem of overdeterrence. *See* Joel Slemrod & Shlomo Yitzhaki, *The Cost of Taxation and the Marginal Efficiency Cost of Funds*, 43 INT'L MONETARY FUND STAFF PAPERS 172, 182 (1996) (describing tax evasion models as implying that it is optimal to prevent all evasion and ignoring the social costs of deterrence).

[234] I am making simplifying assumptions that (i) weak cooperators who enter into informal, not legally binding agreements reduce counterparty risk to the same degree as strong cooperators who enter into no agreements at all, and (ii) the marginal benefit from entering into informal agreements for strong cooperators is diminishingly small (because they already trust each other "fully").

second, loners are overdeterred. Weak cooperators are the only ones who bear the intended risk in both regimes. However, they are cooperating in the second regime but not the first one. Finally, in the first regime many loners and weak cooperators incur market risk, while strong cooperators incur counterparty risk. In the second regime, very few loners incur market risk while both strong and weak cooperators incur counterparty risk. These conclusions may be summarized as follows:

	Strong Cooperators	**Weak Cooperators**	**Loners**
Current Regime	**Underdeterred** *Cooperating*	*Appropriately deterred* Not cooperating	*Appropriately deterred* Not cooperating
Alternative Regime	*Appropriately deterred* *Cooperating*	*Appropriately deterred* *Cooperating*	**Overdeterred** Not cooperating

What are the implications of this comparison? To start, we can answer the question posed at the end of the previous Section. The second regime does more than simply increase market risk. It changes the type of planning used by weak cooperators from traditional to relational. As a result, while in the first regime most planners incur market risk, in the second most assume counterparty risk. By recalibrating the amount of risk and allowing relational tax planning, the government can indeed switch from a primarily market-risk-imposing regime to a primarily counterparty-risk-imposing one. Whether it should do so depends, at least from the economic perspective, on whether this switch is likely to be welfare enhancing.

C. *Assessing the Recalibrated Risk-Based Rules*

Making this evaluation is not easy, primarily because the costs and benefits of the alternative approach depend on scarce empirical data. The most obvious impact of the reform is on innocent taxpayers—those who engage in no tax planning at all. They are plainly worse off under the second approach because they are much more likely to be negatively affected by the recalibrated risk-based rules. An innocent taxpayer who sells a security at a loss with no tax motivations and decides that the company is worth another shot three weeks later needs to wait only a week if she wants to deduct her loss. If the waiting period is extended to six months, the delay is much longer. Furthermore, a chance that this taxpayer would indeed change her mind within a month from the original sale is smaller than the likelihood that she will do so during the following six months. Clearly, longer waiting periods introduce larger distortions in the behavior of innocent taxpayers.

This is a definite weakness of the alternative regime. The extent of the problem, however, is uncertain. The relevant factors are evident. The difference in waiting periods is clearly important, and so is the number of innocent taxpayers whose transactions would be affected by the longer waiting period but not the shorter one. The social cost of forcing these taxpayers to wait the extra time is another pertinent consideration. While these costs are real, it is worth remembering that the costs associated with the existing rules that attempt to reach informal understandings are also considerable, both because these rules are ineffective in deterring relational tax planning and because they are costly to implement when the government attempts to do so.

Another flaw of the counterparty-risk-imposing regime is that it overdeters loners. Some of them will incur costs that (by definition) exceed the social benefit of decreased tax planning.[235] This is clearly inefficient, but it is not obvious whether the resulting welfare loss is larger or smaller than that of underdeterring strong cooperators under the current rules. Those who believe that the existing state of tax compliance should be significantly improved (and many do[236]) may decide that overdeterrence is preferable to underdeterrence.

Serious questions arise regarding the effectiveness of the alternative regime. If, for instance, no (reasonable) waiting period will subject the Wash Seller to counterparty risk that is as significant as the thirty days' worth of unhedged market risk, the alternative regime is

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[235] This is so because loners are assumed to be appropriately deterred by the current market-risk-imposing rules, and the amount of market risk borne by loners will necessarily increase following a switch to the alternative regime.

[236] *See, e.g.*, George K. Yin, *JCT Chief Discusses the Tax Gap*, 107 TAX NOTES 1449, 1449 (2005) ("[A]ny consideration of major tax reform in this country must give primary consideration to issues of tax compliance and enforcement."). The Government Accountability Office named tax enforcement as one of its "High Risk Areas." *See* Allen Kenney, *Tax Enforcement Makes GAO's 2005 List of "High Risk Areas,"* 106 TAX NOTES 531, 531 (2005) ("Given the broad declines in IRS's enforcement workforce, IRS's decreased ability to follow up on suspected noncompliance, the emergence of sophisticated evasion concerns, and the unknown effects of these trends on voluntary compliance, IRS is challenged on virtually all fronts in attempting to ensure that taxpayers fulfill their obligations." (internal quotation marks omitted) (quoting U.S. GOV'T ACCOUNTABILITY OFFICE, HIGH RISK SERIES: AN UPDATE 38 (2005), *available at* http://www.gao.gov/new.items/d05207.pdf)).

not worth pursuing. A related concern is that it will be difficult for the government to evaluate the true magnitude of counterparty risk borne by taxpayers. These problems will loom large if, for example, certain parties succeed in marketing themselves as "trust intermediaries" who will accommodate relational tax planners for a fee. Or we may worry that, taking a page from transaction cost economics, relative strangers will engage in offsetting transactions where each side is the Taxpayer in one trade and the Counterparty in the other. As a result, each party may face an immediate economic loss if she defects on the related trade, making defection less likely.[237] No doubt, many other schemes designed to reduce counterparty risk will be devised by creative minds.

Yet it is unclear whether strategies like these will necessarily succeed. Developing a reputation for the trustworthiness essential to be a successful trust intermediary will take time and effort, and this reputation will be costly to preserve. The intermediary will need to constrain opportunistic counterparties threatening to claim (falsely) that the intermediary betrayed their trust. Because no enforceable contracts will exist to show what the "real" mutual obligations were, rebutting these kinds of charges will be difficult.[238] If large entities (such as investment banks) attempt to assume the role of trust intermediaries, the agency problem may become overwhelming. Monitoring dozens (if not hundreds) of employees who enter into all sorts of tacit understandings with clients may prove impossible. The offsetting trades will hardly be risk free as well. If two parties engage in offsetting wash sales, for example, the chance that the value of both securities will change by exactly the same amount is diminishingly small. In any other case, one of

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[237] This type of planning is akin to an exchange of "hostages" that can be used as a device to overcome opportunism and bounded rationality problems in contracting. *See* Williamson, *Credible Commitments*, *supra* note 75, at 524, 531. The analogy, however, is closer not to "hostages" but to "bonds"—a less effective commitment device. A unique feature of a hostage is that it is valuable to the party giving it, but not to the party receiving it. *See id.* at 526-27. Bonds, in contrast, are equally valuable to both sides. Therefore, bonds are more likely to be expropriated than hostages. *See id.* If the Wash Seller "sells" the loss security to the Wash Buyer and the security doubles in value during the extended waiting period, the increased value is as attractive to the Wash Buyer as it is to the Wash Seller.

[238] While the agreements need not be unwritten in order to be unenforceable as a matter of contract law, the government is free to treat any written agreement as enforceable for tax purposes if it decides that this is needed to reach the desired level of deterrence. This may not be necessary, however, because nothing would stop tax planners from producing competing writings describing their informal agreements.

the parties will have an incentive to defect, and this incentive may be even stronger than in the absence of the offsetting trades.[239]

More generally, only an extreme legal-centric will insist that cooperation that is suppressed by a legal regime will necessarily flourish once the legal constraints are removed. While we can only speculate about what would happen if the government allows currently prohibited relational tax planning, we know quite a bit about what did happen when the government allowed formation of generally illegal cartels.[240] The (perhaps unexpected) answer is that only a few cartels formed, and of those that did, many collapsed within a year or two.[241] This was true even when the government enforced the terms of cartel agreements![242] Collusion, as George Stigler emphasized, "is not free."[243] While the specific difficulties inhibiting cartelization surely differ from those impeding relational tax planning, one of their underlying causes is exactly the same: opportunistic behavior by commercial actors. Granted, Palay's story and the related evidence discussed above[244] suggest that businesspeople locked into a long-term relationship can be quite successful regulatory avoiders. Not all

[239] This will be the case if one security appreciates while the other declines in value. A party who "owns" an appreciated security (to be resold at what turns out to be a below-market price) and has an informal agreement to repurchase a depreciated security (at what turns out to be an above-market price) will be sorely tempted to defect on both trades.

[240] The Webb-Pomerene Act of 1918, 15 U.S.C. §§ 61–66 (2000), and the Export Trading Company Act of 1982, 15 U.S.C. §§ 4001–4003, 4011–4021, granted antitrust immunity to U.S. manufacturing exporters. *See* Dick, *Stable Contracts*, *supra* note 174, at 245-48; Margaret C. Levenstein & Valerie Y. Suslow, *The Changing International Status of Export Cartel Exemptions*, 20 AM. U. INT'L L. REV. 785, 789-90 (2005). The Capper-Volstead Act of 1922, 7 U.S.C. §§ 291–292, and the Agricultural Marketing Agreement Act of 1937, 7 U.S.C. §§ 671–674, awarded antitrust immunity to agricultural cooperatives. *See* Darren Filson et al., *Market Power and Cartel Formation: Theory and an Empirical Test*, 44 J.L. & ECON. 465, 466 (2001).

[241] *See* Andrew R. Dick, *Identifying Contracts, Combinations and Conspiracies in Restraints of Trade*, 17 MANAGERIAL & DECISION ECON. 203, 206 (1996) [hereinafter Dick, *Restraints of Trade*] (reporting that Webb-Pomerene cartels "collectively . . . accounted for just 5% of total manufactured exports," even though cartelization varied significantly by industry); Dick, *Stable Contracts*, *supra* note 174, at 242 ("[N]early one-quarter of Webb-Pomerene agreements collapsed within 2 years . . . ."); Filson et al., *supra* note 240, at 472-73 (reporting that out of 182 possible instances of cartelization, only 39 (or just over 20%) actually occurred, despite the government's assistance in enforcing the cartel's terms).

[242] Agricultural cartels were government enforced. *See* Filson et al., *supra* note 240, at 466.

[243] George J. Stigler, *A Theory of Oligopoly*, 72 J. POL. ECON. 44, 44 (1964).

[244] *See supra* notes 181-191 and accompanying text.

would-be relational tax planners are so positioned, however. More importantly, evidence of successful regulatory avoidance proves that it is possible, not that is it is costless or particularly cheap. Thus, it is far from certain that counterparty risk in the alternative regime will be a weaker friction than market risk is today.[245]

Finally, if it is possible to (roughly) reach the desirable level of deterrence in the alternative regime, what does this mean for weak cooperators who are likely to be the largest group of tax planners? They face the same cost in both regimes, but only as long as they cooperate in the alternative system. Because this is exactly what they are likely to do, weak cooperators are indifferent. But the policymakers should not be. The earlier analysis suggests that the alternative regime has a clear efficiency advantage.

Because the government does not need to deter relational tax planning in the alternative regime, the enforcement costs of counterparty risk do not exceed the enforcement costs of market risk. The same traditional backstop applies in both cases, leading to similar expenditures on audits, litigation, and rulemaking. It is reasonable to assume, therefore, that the two enforcement costs are roughly equal.[246] The same is true of the respective expected tax liabilities. If so, we can eliminate both components from the relevant equations for the purposes of comparing market and counterparty risks, yielding the following simplified summary:

	Market Risk	**Counterparty Risk**
Private Cost	RBL_M	$RBL_C + BC - CG$
Social Cost	RBL_M	RBL_C

We can now observe that for market and counterparty risks that have the same social costs ($RBL_M = RBL_C$), counterparty risk is a stronger deterrent if the bargaining cost exceeds the cooperation gain. For several reasons, this is likely to be the case.

[245] An additional imperfection of the alternative regime is that it will impose varying costs on taxpayers who have different opportunities (and desires) to cooperate. The same is true in the current system, however. Moreover, the existing market-risk-imposing rules are similarly imprecise because, for example, they fail to take into account variability in riskiness of various assets covered by a single waiting-period provision.

[246] The main enforcement cost in the alternative regime will be related to policing the line between enforceable and unenforceable agreements. Modern contract law gives us a good idea about the issues involved.

First, the bargaining cost arises whenever relational tax planning takes place. As long as bargaining is required, bargaining failures occur. The cooperation gain, in contrast, exists only in some cases. When the Taxpayer and the Counterparty have a long-term commercial relationship, reduced transaction costs due to stronger trust may produce considerable savings for the parties. But if the relationship is purely social (like the one between the Wash Seller and the Wash Buyer), or if the two are engaged in a single-shot deal (such as the Acquirer's purchase of the Target from the Seller), the cooperation gain is zero.[247] Because no other exchanges occur, there are no transaction costs to be reduced by enhanced cooperation. Of course, people will cooperate more in the alternative regime than they currently do, and they are more likely to become repeat players. Still, as long as not *all* relational tax planning takes place as part of extensive business relationships, the cooperation gain will be small (or zero) in some cases.

Second, the bargaining cost is a direct cost incurred in the relational tax planning transaction itself. The cooperation gain is a second-order benefit that materializes only in the future. Its impact must be appropriately discounted.

Finally, stronger trust generated by relational tax planning is not a good in itself (at least from the economic perspective). It is the increase in cooperation and decline in transaction costs that matter. The cooperation gain would be large if the parties effectively use trust to reduce transaction costs. Not all relational tax planners will be equally effective.

In sum, it appears likely that, on average, the net effect of the bargaining cost and the cooperation gain in the alternative regime will be an additional loss incurred by relational tax planners. This means that counterparty risk has the same advantage over market risk in the alter-

[247] A hard-nosed economist may point out that relational tax planning involving friends who have no ongoing business relations should lead to stronger personal friendships (just like it should create stronger business ties for long-term business partners). The cooperation gain in this case will reflect private and social benefits of a friendlier society. This may be true, yet I resist this extension because it is much harder to say anything definitive about the cooperation gain when personal friendships are concerned. The rational analysis of defections in business relationships offered above probably does not apply to friends. A relatively minor betrayal in a relational tax planning episode may well damage a friendship substantially, or even ruin it completely. If so, it is ambiguous whether the cooperation gain produced by relational tax planning among friends is, on balance, a private and social benefit or cost. As on other occasions when I encounter this type of uncertainty, I assume that the net benefit or cost is roughly zero.

native regime as business risk has in the existing one. An equally efficient counterparty risk is a stronger deterrent, and an equally deterring counterparty risk is more efficient. This is yet another advantage of the alternative regime.

Clearly—and not surprisingly—the choice between the two regimes involves difficult tradeoffs. The point of introducing and considering the alternative proposal, however, is not to insist on its immediate adoption. Rather, it is to emphasize that a system that is resistant to relational tax planning is conceivable, has several highly attractive features, and is not that different from the one we currently have. In any case, a sweeping reform is not the only alternative to the status quo. Incremental improvements are considered next.

VI. RATIONALIZING EXISTING RISK-BASED RULES: INCREMENTAL IMPROVEMENTS

An effort to make modest improvements to the existing rules immediately runs into an additional complication. Under the alternative approach, most tax planners switch from market risk to counterparty risk for all their tax planning. Thus, the same people face different types of risk while planning around the same rules, and only the aggregate effects are considered. As long as this is the case, it is appropriate to limit the inquiry into the private and social costs of risk bearing to the factors discussed thus far. Once we decide to revise the existing rules, however, we must make case-by-case comparisons of different risks imposed on different taxpayers trying to circumvent different provisions. Elasticity of behavioral responses can no longer be ignored.

To appreciate the importance of taking elasticity into account, consider the recently promulgated constructive sale and constructive ownership regimes. The former triggers recognition of taxable gain if a taxpayer eliminates "substantially all" of her economic exposure to an appreciated asset.[248] The latter forces upon a taxpayer undesirable tax consequences of owning a hedge fund if the taxpayer enters into a derivative that mimics "substantially all" of that fund's economics.[249] Because the economic exposure eliminated in the first case and acquired in the second is tested under the same "substantially all" standard, the two rules appear to subject taxpayers to similar market risk and, therefore, give rise to comparable costs.

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[248] *See supra* note 26.

[249] *Id.*

Yet when David Schizer studied these regimes, he discovered that the similar tests did not translate into similar deterrence. The constructive ownership rule created a discontinuous friction. Most taxpayers stopped entering into constructive ownership transactions, and only a few restructured their trades to satisfy the new statutory requirement.[250] The picture was very different with the constructive sale regime. Here, risk played its typical role of a continuous friction. Once the rule created adverse tax consequences for those who eliminated "substantially all" of their economic exposure, the markets adjusted to deliver hedges that eliminated just a little less than "substantially all" of the underlying economics.[251] The difference in the resulting frictions means that the two regimes—despite their superficial similarity—subject tax planners to vastly different costs even though they appear to impose a very similar amount of risk. Social costs differ as well because one regime stops most tax planning while the other one does not.

Alas, Schizer's study remains the only detailed analysis of frictions produced by risk-based rules. Until we know more about how the multitude of similar provisions operate in practice, the rational (though decidedly imperfect) compromise is to assume equal elasticity for all tax planning strategies.

As long as risk-based rules remain calibrated on the assumption that they impose market risk, and until the numerous statutory references to tacit understandings are interpreted and reconciled (or, better yet, until the universal relational backstop is added to the Internal Revenue Code), the government will continue to respond to relational tax planning on an ex post basis. While the IRS will carry the burden of identifying this type of planning, the ultimate responsibility for evaluating it will lie with courts. Judges will continue to interpret common law doctrines that function as risk-based rules. Therefore, the following discussion focuses primarily on how these doctrines should be revised to account for the unique features of various risks.

A. *Comparing Market, Business, and Counterparty Risks*

Even the admittedly reductionist economic analysis developed in this Article demonstrates that market, business, and counterparty risks differ in important respects. Comparing market risk imposed by one

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[250] Schizer, *Frictions*, *supra* note 10, at 1318, 1372-74.
[251] *Id.* at 1318, 1374.

rule to counterparty (or business) risk resulting from another—even putting elasticities aside—is very much like comparing apples to oranges (or pears). Yet there is little doubt that courts make these comparisons all the time, even if implicitly. When a taxpayer engages in relational tax planning around a clear risk-based rule (as in the friendly wash sale example), the analysis is easy because two conclusions are clear. First, the private cost of incurring counterparty risk is *lower* than the private cost of incurring the corresponding market risk. If it were not, the taxpayer would simply forgo relational tax planning. Second, the cost of incurring counterparty risk is *too low* because the cost of incurring market risk is set by a clear rule (thirty days, in the wash sale case).[252]

If either conclusion is questionable, the analysis becomes much more difficult. The first conclusion is in doubt when there is no market (or business) risk analogue to counterparty risk in a given setting. Recall the one-year waiting period imposed by Congress to deter heartless taxpayers from giving appreciated assets to their dying relatives in a hope of receiving them back as a bequest. This scheme has no arm's length equivalent. Strangers do not leave bequests to strangers. In any other case, the risk is different.[253]

The second conclusion cannot be reached when the appropriate level of market (or business) risk is itself uncertain. For instance, there is no general rule that a given holding period establishes tax ownership *in the absence* of any relational tax planning.[254] When a dealer sells municipal bonds to a bank under a repo, we know that an informal understanding between these parties reduces their risk.[255] But what amount of risk is sufficient without any tacit agreements? If a repo between total strangers lasts a month, is this long enough to treat the transaction according to its form? There is no clear answer to this question. Without

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[252] For simplicity, I ignore the fact that the wash sale provision allows some formal hedging.

[253] This is because, in any other case, the Counterparty's decision will be affected by the value of the asset received as a "gift" from the Taxpayer and the temptation to retain it for personal gain. When the Counterparty is a decedent, this analysis clearly does not apply.

[254] In fact, a variety of waiting periods apply in very similar settings. *See supra* note 129. For a discussion of the profound uncertainty surrounding the concept of tax ownership, see Alex Raskolnikov, *Contextual Analysis of Tax Ownership*, 85 B.U. L. REV. 431 (2005).

[255] More precisely, this used to be the case before the repo market became formalized. *See* STIGUM, *supra* note 81, at 218-21.

it, how does one decide whether one month is long enough if the repo participants are long-term business partners?[256]

How do courts and Congress resolve these types of cases? Why is one year (and not ten) the right waiting period for a heartless relative? What justified a conclusion that seven to nine months (and not thirty days) was long enough in the liquidation-reincorporation sequence? Putting aside pure guesses and disregarding precedents (that had to come from somewhere), the only plausible explanation is that courts and legislators compare different types of risk that arise in different situations. How these comparisons are made is a mystery of the legislative process and the miracle of common law. What is important for our purposes is that they are being made time and again.

If so, the analysis offered in this Article suggests some considerations that would make these comparisons more educated (that is, more reflective of real costs and benefits faced by tax planners).[257] First, when comparing market and business risks (for instance, a wash sale waiting period with a liquidation-reincorporation holding period), courts should be aware of the additional cost imposed by the latter—the expected business loss ($\alpha_B \times L_B$). Because business risk is costlier than market risk, it should be imposed more sparingly. Thus, assuming courts somehow decided that in light of a thirty-day wait in a wash sale context the appropriate waiting period under the liquidation-reincorporation test is seven to nine months, they should reduce that waiting period (say, to five to seven months) to take account of the expected business loss.[258]

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[256] To take a business risk example, consider the special provision designed to deter drop-and-sell schemes. If an owner selling her business incorporates it having already reached an informal agreement to sell the newly received stock, the risk is lower than if no such agreement exists. It is unclear, however, how long an owner must hold the unwanted stock without any implicit understandings about the stock's future sale in order to satisfy the requirement that she control the corporation "immediately after the exchange." I.R.C. § 351(a) (2000).

[257] Admittedly, since it is unclear how courts and policymakers make these comparisons today, one can never rule out a possibility that their decisions already reflect the analysis offered below.

[258] In fact, judges may even take into account the magnitude of the expected business loss. It may be reasonable to conclude, for instance, that this loss is relatively high when a taxpayer must close her business and later restart it anew, lower when she must operate the business without limited liability (both scenarios are possible in the liquidation-reincorporation case), and lower still when she must continue to own the business in an incorporated form for some time (the drop-and-sell scenario). The substance-over-form and step transaction doctrines are clearly broad enough to allow these types of inquiries.

Second, when comparing market risk to counterparty risk incurred in a one-off business transaction (such as the Seller's sale of the Target to the Acquirer), courts should change nothing in their current approach. This is so because counterparty risk may be a stronger or weaker deterrent than market risk in this setting. The cooperation gain here is zero, while the bargaining cost is positive, suggesting that counterparty risk gives rise to a relatively larger private cost than market risk. On the other hand, the expected tax liability is smaller for counterparty risk (the likelihood of detection, and, therefore, α_C, is very low for relational tax planners today), making it a weaker deterrent. Because it is unclear which of these effects predominates, there is no compelling reason to disturb the existing doctrine.

B. *Evaluating Counterparty Risk in Different Settings*

Many cases of relational tax planning, however, do not involve one-shot deals between strangers. Exchanges among friends, relatives, and long-term business partners clearly involve less risk. Courts already take this into account.[259] This is entirely appropriate because lower risk means lower risk-bearing loss and smaller "price" for capturing the desired tax benefit. What the current doctrinal approach lacks is a recognition that the extent of commercial relationships should be considered *beyond* the evaluation of the level of trust (and, therefore, risk) among relational tax planners. This makes the current law insufficiently nuanced but may be easily remedied.

Several fairly uncontroversial assumptions must be made before proceeding to concrete recommendations. First, it is reasonable to posit that the cooperation gain reflects only a reduction of transaction costs and not a change in the relationship's scope.[260] Second, the ex-

[259] *See, e.g.*, Kornfeld v. Comm'r, 137 F.3d 1231, 1235 (10th Cir. 1998) ("[Where] the parties to the transactions in question are related, the level of skepticism as to the form of the transaction is heightened, because of the greater potential for complicity between related parties in arranging their affairs in a manner devoid of legitimate motivations." (internal quotation marks omitted) (quoting Gordon v. Comm'r, 85 T.C. 309, 325-26 (1985))).

[260] This is not always true. For instance, as Lisa Bernstein and Barak Richman explain, the diamond trade is impossible without a high level of trust between the traders. *See* Lisa Bernstein, *Opting Out of the Legal System: Extralegal Contractual Relations in the Diamond Industry*, 21 J. LEGAL STUD. 115 (1992); Barak D. Richman, *How Community Institutions Create Economic Advantage: Jewish Diamond Merchants in New York*, 31 LAW & SOC. INQUIRY 383 (2006). In this kind of environment, an increase in the cooperation

tent of informal relational contracting can be inferred from the size of formal interactions.[261] Third, it is unrealistic to expect that courts can determine the social value of the cooperation gain on a case-by-case basis at a reasonable cost.[262] Therefore, courts should ignore it altogether. Finally, it is useful to compare situations where the *only* difference is the cost of incurring counterparty risk. For instance, assume that the tax planning in question always involves a Taxpayer hoping to capture a tax benefit of the same size by owning an asset she does not want to own (or not owning an asset she wants to own) for a period of time.[263] Marginal deterrence considerations suggest that in this case we would want all Taxpayers to bear the same cost regardless of the nature of their relationships with Counterparties.[264]

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gain may produce a discontinuous change from almost no contracting to an extensive relationship.

[261] This is probably a conservative assumption. As transactors develop trust, the share of informal contracting tends to rise. *See, e.g.*, Bensaou & Anderson, *supra* note 160, at 475 (finding that more multifaceted, intense, and eventful buyer-supplier relationships produce larger relation-specific investments indicative of stronger trust). Therefore, the more extensive the relationship, the less formal it is likely to be.

[262] The parties have no incentive to reveal information about their additional relational tax planning because this information would tend to suggest that the cooperation gain is a social cost and courts should be particularly unforgiving. At the same time, self-serving evidence of non-tax-motivated informal contracting will be highly unreliable. The evidence will be self-serving because it will tend to show that relational tax planning facilitates socially valuable commercial exchanges, suggesting leniency from a court. Unlike in contract disputes, where one of the parties has an incentive to demonstrate the course of dealing or the course of performance while the other party has an incentive to dispute this showing, neither the Taxpayer nor the Counterparty will have a reason to assist the IRS in questioning the evidence of socially valuable non-tax-driven relational contracting that is certain to be produced by the Taxpayer in order to argue that the cooperation gain is positive for the society as a whole.

[263] Even this fairly narrow description covers wash sales, dividends-received deduction and foreign tax credit schemes, norm-based and bilateral repos, *see supra* notes 71 and 82, the heartless relative example, *see supra* text accompanying note 222, the Parent/Children example, *see supra* text accompanying note 223, the drop-and-sell situation, *see supra* text accompanying note 52, some liquidation-reincorporation cases, *see supra* text accompanying note 54, and many other situations. *See, e.g.*, United States v. Cumberland Pub. Serv., 338 U.S. 451 (1950); Comm'r v. Court Holding Co., 324 U.S. 331 (1945); Walker v. Comm'r, 544 F.2d 419 (9th Cir. 1976); Steel Improvement & Forge Co. v. Comm'r, 314 F.2d 96 (6th Cir. 1963).

[264] The basic insight is that if there are ten alternative relational tax planning strategies, and if taxpayers will receive tax benefits of equal value by pursing any one, they are indifferent about which strategy to follow as long as the costs are the same. If, however, pursuing any of the nine strategies costs 10 (dollars or utility units) while following the tenth one costs only 2, the effectiveness of 90% of the rules designed to deter relational tax planning is undermined because taxpayers will simply reduce their taxes by following the tenth strategy. (Eventually their marginal cost may rise to the level of following the other nine, but by then a lot of tax planning will have occurred.)

Once these assumptions are accepted, conclusions readily follow. "Thicker" commercial relationships have lower bargaining costs and larger cooperation gains than "thinner" ones.[265] Bargaining costs are lower because the very existence of an extensive relationship reveals that the parties have learned to overcome bargaining problems.[266] Cooperation gains are larger because the more contracting takes place, the larger the transaction cost savings.[267] At the same time, the expected tax liability is smaller for thicker relationships. This is so because enforcement is particularly difficult when parties have many ways of compensating each other indirectly for the mutual "favors" conferred in relational tax planning episodes (i.e., β_C is relatively small). In a thin relationship, a resale of a loss security on nonmarket terms, to take one example, is much more obvious (β_C is relatively large). This analysis suggests that relational tax planning has a lower private cost when it accompanies thicker relationships compared to thinner ones. At the same time, its social cost is likely to be higher for thicker relationships due to larger enforcement costs.

Courts are already more suspicious of tax benefits arising from relationships that have higher levels of trust, and they appear to recognize that more extensive business interactions (like the one between the Liquidator and the 21-Holder) correspond to stronger trust.[268] The same is true of stronger friendships, however (such as the one be-

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For a fuller discussion of marginal deterrence in tax administration, see Alex Raskolnikov, *Crime and Punishment in Taxation: Deceit, Deterrence, and the Self-Adjusting Penalty*, 106 COLUM. L. REV. 569, 609-12 (2006).

[265] A relationship is "thick" if it is multifaceted, intensive, and potentially long lasting. For a similar use of the term, see Melvin Aron Eisenberg, *The Limits of Cognition and the Limits of Contract*, 47 STAN. L. REV. 211, 251 (1995).

[266] *See, e.g.*, Bensaou & Anderson, *supra* note 160, at 475.

[267] It is worth noting that at some point the cooperation gain will start declining as the relationship becomes thicker. An assumption that marginal returns to trust decline as the trust grows appears plausible. If the Taxpayer already trusts the Counterparty "like a brother," there is not much room for improvement. Few commercial parties, however, are likely to approach this level of trust.

[268] Opinions routinely emphasize that a particular counterparty is a taxpayer's long-term customer, employee, and so on. *See, e.g.*, Granite Trust Co. v. United States, 238 F.2d 670 (1st Cir. 1956) (taxable liquidation case, 21-Holder is the Liquidator's long-term customer); Comm'r v. Day & Zimmermann, 151 F.2d 517 (3d Cir. 1945) (taxable liquidation case, 21-Holder is the treasurer of the Liquidator); Citizens Nat'l Bank of Waco v. United States, 551 F.2d 832 (Ct. Cl. 1977) (isolated repo case, the Counterparty is a long-term bank of the Taxpayer).

tween the Wash Seller and the Wash Buyer).[269] Yet the two types of cases are different. Only the parties to a thick commercial relationship are relatively unaffected by the bargaining problems. Only for them is the cost of tax planning reduced by a considerable cooperation gain. Relational tax planning is cheaper for these taxpayers than it is for social friends. It is also more socially costly. Therefore, courts should scrutinize counterparty risk incurred by parties who belong to thick commercial relationships even more than they do today.[270]

The analysis of multilateral risk cases is very similar. Even fewer assumptions are required here. We no longer need to infer the magnitude of informal cooperation from the extent of formal contracting. Norms are by definition informal.

The thicker the norm environment, the larger the cooperation gain.[271] More norms mean more informal transacting that can benefit from reduced transaction costs. The bargaining cost of incurring multilateral risk is small in any case: not much bargaining is needed when the parties follow a norm. As with thicker dyadic interactions, thicker norm environments produce smaller expected tax liabilities. Thus—with an important caveat discussed below—courts should be most demanding when they consider relational tax planning among contractors who belong to a thick norm environment. Similar analysis suggests that a thin norm-based exchange should be scrutinized more than a thick bilateral relationship.[272]

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[269] *See, e.g.*, Stein v. Comm'r, 36 T.C.M. (CCH) 992 (1977) (friendly wash sale case, the Counterparty is a Taxpayer's friend, but the two have no ongoing commercial relationship).

[270] For example, assume that it is sufficient for the Taxpayer to part with (or hold) the asset under an informal agreement with an occasional business partner for two months. If the same transactors have extensive commercial dealings, the waiting period should be longer (say, three months). Obviously, the numbers are used just to illustrate the progression. Taking a more general approach relying on the current step transaction doctrine, assume that the one-off deal is scrutinized under the doctrine's least far-reaching binding commitment version. A more expansive interdependence test should then apply to a thick relationship. *See* Comm'r v. Gordon, 391 U.S. 83, 96 (1968) (establishing the binding commitment test); McDonald's Rests. of Ill., Inc. v. Comm'r, 688 F.2d 520, 524-25 (7th Cir. 1982) (enunciating the interdependence test). Note that this conclusion is independent of the level of trust between relational tax planners. While thick relationships usually correspond to high trust, an occasional business deal between long-term friends may also take place in a high-trust setting. The former should be scrutinized more for the reasons discussed in the text.

[271] A norm environment is "thick" if its members follow many different norms in their interactions with each other.

[272] The cooperation gain may be larger in a thick bilateral relationship (when parties follow only one or two norms in a thin norm environment, enhanced trust can

One caveat to this analysis must be made to take account of welfare-maximizing norms. The earlier discussion of multilateral risk concluded that it is difficult to decide in the abstract whether the general externality is socially positive or negative. When judges consider individual cases, however, more can be done. Litigants cannot make up socially valuable tax-neutral norms just to support their tax positions.[273] If they manage to present convincing evidence of a thick environment involving many norms that produce no apparent tax savings, courts should be somewhat more lenient than otherwise. Granted, taxpayers will hide tax-driven norms from the court. Still, the mere presence of many tax-neutral norms will suggest that the general externality is positive, making the tax planning in question relatively less costly for society. At the same time, if taxpayers relying on a tax-reducing norm are unable to describe any tax-neutral norms that exist among the same transactors, a court could reasonably infer that the general externality is small or negative. If so, the previous conclusions about stronger scrutiny of norm-based relational tax planning apply.

Comparisons between dyadic and norm-based interactions are useful only if courts can distinguish between the two at a reasonable cost. In some cases, they should be able to do so rather easily. First, the government may know about widespread tax-driven norms even before it initiates litigation. In fact, this knowledge may be the reason why the government decides to litigate in the first place. The recent wave of tax shelter controversies comes to mind. The unstated custom of assuming that tax shelter clients have a business purpose for enter-

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smooth only a few interactions), and the bargaining cost is probably low in both settings. Yet the key difference is in the amount of risk. Sanctions for defection in a norm environment are stronger because a failure to follow a norm will be punished not only by the offended party, but by many other members of the group as well. This risk-reducing effect of norms almost certainly overshadows the difference in the cooperation gain. Continuing with our example, the holding period for a Taxpayer who follows a well-established but isolated norm should be, say, four months (that is, longer than the three months required for an extensive dyadic relationship). If the norm environment is thick, only holding the asset for half a year should be enough to capture the tax benefit. More broadly, the most far-reaching end result version of the step transaction doctrine should apply to norm-based exchanges. *See McDonald's Rests.*, 688 F.2d at 524 (explaining the end result test).

[273] Evidence of socially valuable norms is much less falsifiable than evidence of non-tax-motivated relational contracting because a court may demand independent verification of the existence of norms.

ing into questionable mass-marketed schemes is well known to the IRS.[274] The agency is making the courts aware of this as well.[275]

Second, the market practice may be so established that a basic inquiry into the structure of the taxpayer's business would readily reveal it. The fixed-price repurchase norm that prevailed in repo markets for decades is a good example. Not only were courts aware of it, but the opinions described the practice in considerable detail.[276]

Finally, courts themselves are quite capable of identifying some business norms at a very low additional cost. All it takes is to keep their possible existence in mind while judges analyze relevant precedents. The apparent informal understanding among wealthy benefactors and charitable organizations could be readily discovered in this fashion. When case after case describes how donors rely on charities to do what would be desirable for the donors, and charities end up following the donors' wishes time after time without being formally obligated to do so, a reasonable inference arises that the parties know how to dance this dance before the music starts playing. The norm reveals itself.

No doubt, these techniques will not identify all settings that involve multilateral risk. But they will surely expose a few, and where they do, courts should recognize the type of risk involved. More generally, I am not making a naïve suggestion that courts should attempt precise evaluations of the thickness of a dyadic relationship or a given norm environment, the social value of tax-neutral norms, and the like. But it is clearly a mistake to ignore these considerations. Courts (and the IRS) *already* distinguish between high- and low-trust interactions. They are *already* aware of certain environments where norms are widespread. They *already* compare (even if implicitly) different types of risk imposed by different statutory provisions. Taking account of whether tax planners have a personal or business relationship,

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[274] *See, e.g.*, James M. Peaslee, *Circular 230: Make Room for Informal Written Advice*, 106 TAX NOTES 1457, 1457 (2005) (referring, in a letter to the IRS, to "some practitioners [who write] low-grade, canned tax opinions" that "assume a business purpose or profit motive where none exists"). The government has certainly taken notice. *See, e.g.*, Circular 230, 31 C.F.R. § 10.35(c)(1)(ii) (2007) ("[I]t is unreasonable [for a tax practitioner giving an opinion] to assume that a transaction has a business purpose.").

[275] *See, e.g.*, Long Term Capital Holdings, LP v. United States, 150 F. App'x. 40, 42-43 (2d Cir. 2005).

[276] *See, e.g.*, First Am. Nat'l Bank of Nashville v. United States, 467 F.2d 1098 (6th Cir. 1972); Union Planters Nat'l Bank of Memphis v. United States, 426 F.2d 115 (6th Cir. 1970); Am. Nat'l Bank of Austin v. United States, 421 F.2d 442 (5th Cir. 1970); Am. Nat'l Bank of Austin v. United States, 573 F.2d 1201, 1205 (Ct. Cl. 1978).

whether the business relationship is extensive, and whether tax planning relies on social norms is not only possible but is fairly easy to do in many cases. Using this additional information along the lines suggested here will make the current law more rational and will improve marginal deterrence.

CONCLUSION

This Article highlights the problem of relational tax planning and offers a more sophisticated understanding of various risks. The resulting insights lead to a range of proposals—from a sweeping (and counterintuitive) reform to a series of incremental improvements. All proposed solutions have costs as well as benefits; all involve tradeoffs. Moreover, relational tax planning is surrounded by pervasive uncertainty. The magnitude of the cooperation gain and bargaining cost, the cooperation gain's social value, the robustness of the alternative counterparty-risk-imposing regime, and other critical issues are unlikely to be ever resolved with absolute confidence.

This uncertainty, however, should not obscure the conclusions that are anything but tentative. Relational tax planning is a serious problem. Market, business, and counterparty risks have different private and social costs. Some of these differences—such as the business risk's superiority over market risk and the diminishing cost of incurring counterparty risk for thicker dyadic relationships and norm-based exchanges—are quite clear. A regime where risk-based rules impose primarily counterparty risk is possible and, in fact, not that different from the existing one. In many cases, adjusting the current judicial doctrines to take account of the unique features of business and counterparty risks is neither conceptually difficult nor prohibitively costly. We have more than enough information to make intelligent judgments about possible reforms.

Perhaps this Article will convince policymakers to embrace the sweeping overhaul of the current risk-based rules. Or they may do just the opposite and tighten the existing doctrines along the lines of the incremental reform proposals. Whatever the case, recognition of relational tax planning as a unique and complex phenomenon—and nuanced analysis of its distinctive features—are critical in assuring that *any* revision of risk-based rules is based on more than simplistic arguments and outdated intuitions. Relational tax planning has been ignored for too long. It is time to give it serious consideration.