# Double Blind Lawmaking and Other Comments on Formalism in the Tax Law

*Saul Levmore*†

David Weisbach's Article for this Symposium, *Formalism in the Tax Law*,[1] is intriguing and accomplished. It wastes no time in putting some meat on the skeleton of debates about formalism. I do not summarize it here. Readers will know that it emphasizes the one-way nature of anti-abuse rules; the possibility of a link between standards and simplicity; the idea that behavior will change (in tax law and perhaps in other legal fields where there is behavioral elasticity) in response to a "first mover's" rulemaking strategies; and the importance of thinking about discontinuities in rules because these gaps in tax law might stimulate arbitrage, litigation, and the like. In the end, we are convinced that tax law relies sensibly on anti-abuse rules of a fuzzy sort precisely because taxpayers are quite able to adapt their behavior once the government makes nonfuzzy first moves. Weisbach's clever way of putting this point is to say that in tax law there is the danger that the uncommon will become common. Slightly underinclusive rules become grotesquely so. Formalism, if we must put it that way in this Symposium, would encourage waste. In this Comment I address the one-way character of anti-abuse rules and then this problem of the uncommon becoming common.

## I. ONE-WAY RULES

Weisbach hints that we ought to be suspicious of the one-way nature of the anti-abuse rules recently made a part of our tax code. The government insists that it can question the formalities used by a taxpayer in order to assert that the substance of the transaction suggests a different tax treatment than that claimed by the taxpayer. But the government does not normally allow for the possibility that the taxpayer might choose some formalities and then ask for a tax treatment that normally applies to different formalities, even though the substance of what the taxpayer did might have allowed the second set of formalities. Thus, if a corporate taxpayer redeems stock held by shareholders, the gov-

† William B. Graham Professor of Law, The University of Chicago Law School.

[1] David A. Weisbach, *Formalism in the Tax Law*, 66 U Chi L Rev 860 (1999).

ernment might assert that the redemption was "really" a dividend. But if the taxpayer distributes dividends, the taxpayer is not normally allowed to claim later that "really" this dividend was a redemption. Similarly, a taxpayer that calls an entity a partnership cannot later assert that it was a corporation in substance, although the government might so recharacterize a business entity.

There is nothing remarkable about this characteristic of the anti-abuse rules. This is not a setting where we ought to expect symmetry in legal rules. Consider, for example, the one-way nature of private rules such as the rule in take-it-or-leave-it airline "contracts," which informs ticket holders that seats will be forfeited if passengers do not appear at the gate at least fifteen minutes before scheduled departure. Some restaurants and athletic clubs do the same; reservations are said to be held no more than fifteen minutes after the assigned times.

These rules are one-way in two ways. First, they are not symmetrical in the sense that the same fifteen minute rule is not applied to, or even expected of, the other party to the arrangement. If the passenger arrives in a timely fashion but the aircraft is late, the airline owes nothing. Indeed, it need not allow the passenger to back out of the contract. Similarly, the restaurant that pushes eager patrons to the bar for a long wait need not pay, though here the customer can withdraw easily, albeit without collecting reliance or other damages.

This asymmetry is sensible, as every contracts student learns, because there is no reason to think that the parties to any of these arrangements value time or inventory in an identical fashion. A given passenger might value her time more or less than the airline, such that she might (or might not) be willing to pay a premium for a reservation that came with the understanding that, in the event of delay, the airline would roll up a spare aircraft or would avoid delay by scheduling flights with unusually large margins of safety in terms of turnaround time. At present, no developed market exists for this sort of travel, but the point is that it is not clear that passengers would pay for it—and there is certainly no reason to think that the default rule in contracts should amount to an assumption that passengers value their time exactly as the airline values its passengers' timely presence. There may of course be some gain in arguing for such a rule. A doctor who announces that a missed appointment will cost the patient one hundred dollars might be amused or fooled into thinking it only fair or legal to refund that amount to the patient if the doctor is called elsewhere and does not materialize as promised. But most contracting parties recognize that unilaterally fashioned rules are just that. One-way rules are not normally suspect, and may not even be surprising.

Similarly, some taxpayers might well be willing to pay a great deal for an ability to elevate substance over form. They might be willing to pay for the ability to choose their form of doing business through a kind of "check the box" scheme. They might even be willing to pay more for the right to do this with the benefit of hindsight—an end of year election rather than an educated guess before doing business. But there is no reason to think that the average taxpayer would value this enough to compensate for the increased tax rates that all would need to pay for such a rule. The tax collector, like most airlines and restaurants, would likely "pay" more than would taxpayers for rules giving it flexibility and the right to insist that formalities are weapons to be used against taxpayers exclusively—never to be turned upon the tax collector by the taxpayers. The overwhelming majority of taxpayers, airline passengers, and restaurant patrons are, in an important sense, willing to accede to one-way anti-abuse rules.

Second, these anti-abuse rules are also one-way in that they are options for the rulemaker. An airline can hold passengers to their reservations if these passengers are late. It is even conceivable that an airline would refuse to seat a passenger even if it had empty seats or a delayed departure when the passenger was late, for such a practice might encourage early arrival next time when it matters. There is every reason to think that the airline is in the best position to make this judgment. Much in the same way, the government is not required to deny taxpayers their attempts to "abuse" formalities.

One-way anti-abuse rules are thus notable but not remarkable. Indeed, the one-way quality of the airline example might be described as a safe harbor. Setting aside "bumping" rules as they apply to overbooked flights, the airline's position is essentially that the passenger is safe if the passenger checks in fifteen minutes before the scheduled departure but that the passenger will often—but not always—do just as well coming a bit after that time. This is exactly what safe harbor rules do in tax law. The law might announce that in a corporate combination if old equity holders of a firm receive more than 50 percent of their consideration in new equity then they qualify for tax-free reorganization treatment.[2] It might state that a redemption of shares safely re-

[2] See Rev Proc 77-37, 1977-2 Cum Bull 568, 569 (taking position that for ruling purposes at least 50 percent of consideration must be stock to qualify under IRC § 368(a)(1)

ceives exchange treatment if the shareholder's ownership percentage drops by a certain amount.[3] In such situations it is possible to enjoy the same favorable treatment outside of the safe harbor.[4] But then one must argue or hope to show that the problem addressed in the Code is not raised by allowing the particular taxpayer to enjoy exchange treatment, reorganization treatment, or other such "favors." The government behaves here exactly as do the airlines, offering a safe harbor but sometimes allowing for the same treatment outside the shelter of the harbor. By operating outside of the safe harbor, the taxpayer faces some risk and perhaps legal costs, but overall the safe harbor approach seems perfectly sensible.

Similar safe harbors exist in many areas of law. I refer to them not as proof that they belong in tax law as well, but rather as suggestive of the idea that, where one area of law resembles others, and especially where there is similarity to evolved, private arrangements, it is likely that the common feature is a desirable one. Having thus far referred to private arrangements, it may be useful to note a safe harbor in public law. Consider, for example, statutes of limitations, which normally provide safe harbors for those who wish for their claims to be regarded as timely. The limitation period may on the margin affect the pace at which potential litigants gather information as well as their inclination to abandon some other strategies for resolving disputes. The statutory period also promises a period during which potential litigants need not rush their claims or fear dismissal for tardiness. If there were no such certain periods for bringing claims—which is to say if applications of and disputes about laches or seemingly untimely claims dominated the landscape—then the absence of a safe harbor would likely encourage earlier unnecessary filings.

## II. DOUBLE BLIND RULES

I turn to the dynamic nature of tax law and taxpayer adaptations, and to the claim that the uncommon becomes common. There is no need to dwell on the question of whether this danger or feature is unique to tax law. Indeed, my suggestion in this Sec-

(1976)).

[3] See IRC § 302(b)(2) (1994) (applying exchange treatment if percentage of voting stock held by shareholder falls by more than 20 percent and to a point below 50 percent).

[4] See IRC § 302(b)(1) (providing exchange treatment for redemptions "not essentially equivalent to a dividend" even though they do not meet the ownership drop formalized in the safe harbor of section 302(b)(2)). The same might be said of IRC § 368(a)(1)(A), which allows for reorganization treatment in transactions that are less well defined ("a statutory merger or consolidation") than those provided for later in subsections (a)(1)(B)-(C).

tion increases in value if the uncommon often (inefficiently or undesirably) becomes common in response to rulemaking. If the problem is that the government as rulemaker suffers from a kind of first-mover disadvantage, because taxpayers design their transactions to avoid the known rules, then consider what would happen if the government denied taxpayers information about these rules. Of course, if taxpayers fashioned their transactions and *then* the government designed its rules, the problem (if it is a problem) would be reversed. Taxpayers would have the first-mover disadvantage and there would be the danger that the government would draft inappropriate rules in order to collect more revenue. From an efficiency perspective, taxpayers might be overly constrained because of their fears about the likely content of the second mover's rules. In an important sense, this is the objection to some retroactive rulemaking. A government that can pass rules with retroactive application enjoys the position of second mover, for better and for worse.[5]

Imagine now a scheme in which the government wrote the rules, but withheld complete information about their content. Thus, the government might announce that there would indeed be capital gains treatment for assets held somewhere between three months and five years, but that the precise holding period would not be revealed until after the end of the tax year. Taxpayers would lose their second mover advantage but so would the government. This application of double blind rules falls somewhere in between current practice and strong-form retroactivity. The government must draft these rules without complete knowledge of taxpayers' transactions but in turn taxpayers must act with incomplete knowledge of the rules they wish to avoid (or enjoy). Note that the five-year upper bound in the illustration offers a safe harbor; double blind rules can retain the advantages of safe harbors.[6] Weisbach's Article might serve as a useful reminder that there is room for some creativity and experimentation with double blind rules. And if this is not the case, which is

[5] See Saul Levmore, *The Case for Retroactive Taxation*, 22 J Legal Stud 265 (1993); Daniel N. Shaviro, *The Law and Economics of Tax and Other Retroactivity* (Nov 1998) (unpublished manuscript on file with U Chi L Rev).

[6] Double blind rules are not entirely unknown. Thus, there is the idea, offered some time ago by Jeffrey O'Connell, that settlements might be promoted by offering parties a means of avoiding the danger that they reveal weakness by making a settlement offer. Offers can be communicated to a third party who announces when two disputing parties have generated a range for settlement. Different rules for establishing settlement points can be agreed to in advance of these blind offers. For some formal exploration of the idea, see Robert H. Gertner and Geoffrey P. Miller, *Settlement Escrows*, 24 J Legal Stud 87 (1995) (arguing in favor of double blind settlement resolution).

to say if it is unlikely that less information is here better than more, then perhaps the concern with the uncommon becoming common is misplaced. The dynamics of adaptation may be annoying but not terribly inefficient.

There is, moreover, a sense in which our tax law (not to mention other law) has long ago taken steps toward this double blind rulemaking strategy. We often see a fuzzy statute generating adaptive behavior by those it regulates and, in turn, by regulators—but then judges intervene and turn the earlier standards into ex post rules, or at least half-rules in the form of safe harbors. These rules may come too late to provide taxpayers with certainty, but they do offer an advantage in terms of decreasing reporting and enforcement costs. We might think of this tradition of midstream judicial rulemaking as reflecting or even encouraging a kind of double blind strategy as between regulators and those who are regulated.

## III. A NOTE ON DISCONTINUITIES

If a motorist who exceeds the speed limit of 55 pays a huge penalty when nabbed going 56 miles per hour, but one who drives 55 pays nothing, then in the face of uncertainty motorists may drive not 55 but 45 miles per hour. In this example a discontinuous liability rule appears to lead to excessive precautions. But in other cases there will be less uncertainty as to the accuracy of the factfinder or one's own speedometer, or perhaps the liability rule will be discontinuous but damages will be calculated incrementally. If the speedster pays in damages only the *extra* costs associated with driving 56 rather than 55, then there is no serious discontinuity to avoid. Weisbach properly leads the reader to the counterintuitive idea that "cliffs," or discontinuities, do not necessarily lead to more precautions.[7]

Still, since discontinuities may lead to "excessive" avoidance strategies, Weisbach is surely correct to point out that rules are generally more discontinuous than standards.[8] We should note that this comparison may be the source of safe harbors' value—safe harbors minimize the problem of discontinuities. There is also the interesting claim that discontinuities generate arbitrage or inefficient offsetting positions. Here I would simply add the observation that ex post rules (where the government is the second mover or perhaps the double blind mover whose rules are unknown until afterward) might not generate arbitrage. In any

[7] Weisbach, 66 U Chi L Rev at 873 (cited in note 1).

[8] Id at 874.

event, it is surely the case that double blind rules would generate less arbitrage than would rules put forth by a first mover.

Here, as in so many other areas of tax law, there is much to be gained by drawing comparisons to other areas of law. I have suggested that one-way rules look better when we see their prevalence elsewhere. Double blind rules may be useful in a variety of settings, although I do not pretend to have shown that they are well accepted elsewhere. Finally, the problem (or lack thereof) of discontinuities is found in many settings, but here tax commentators have avoided the mistake of thinking that tax law is an island with little to learn from or to offer other areas.