The Erwin N. Griswold Lecture

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I am immensely pleased to be introduced by my long-time friend and colleague, Mike Graetz. One of the great delights of teaching is to have a brilliant student and watch him carve his niche at the top of his profession. I just wish Mike had studied taxes with me at law school.

Mike was my brightest student in my seminar in Computers and the Law, which I had the audacity to teach at Virginia back in 1967 when computers were in their infancy. I think he signed up for the seminar because he was confident I did not know as much about computers as my students, and with his usual perception he was right. We had great fun doing such innovative things as programming the computer to act as a witness to be cross-examined by budding student litigators.

But as I have often reminded Mike, he took basic income tax from another professor. Nonetheless he so impressed John Nolan and others at Treasury that he became one of the very few students just graduating from law school ever hired on the Treasury tax legal staff. Despite sporting a Fu Manchu moustache, a brown corduroy suit, and a puckish sense of humor, he promptly became a mainstay of our Treasury team.

Now as you have heard, Mike has written the first review of my recently published book. My mail and telephone calls seem to show that many more people have read Mike's review in Tax Notes than have read my book, indicating perhaps that his review may make the best seller list and end up as a Hollywood movie. If so, Mike, you may hear from my lawyers. In a few moments I shall take advantage of this opportunity to comment on one of the themes in Mike's review.

Before doing so, however, I want so say how deeply I am honored to have been asked to present the third annual lecture that the College has created in the name of that distinguished scholar, Erwin N. Griswold, who, sadly, passed away some two months ago. I need not relate to you his many achievements, nor recount his sterling service in the development of the nation's tax law.

I recall with gratitude the pleasure I had almost a half century ago when in the American Law Institute I appeared many times with the late Professor Stanley Surrey and others before a distinguished panel that included Erwin, Norris Darrell, Randolph Paul, and Robert Miller, seeking approval of a proposed revision of the corporate tax provisions in the Internal Revenue Code. They were all superb lawyers and rigorous interrogators, and Erwin was second to none.

Boris Bittker, who gave the second lecture last year, has also been one of the great scholars of our generation, and it has been my pleasure to have known Boris these many years.

I thought at length about why I might have been chosen to give the third of these lectures, and I am hesitant to mention the link that occurred to me. Some twenty-five years ago, when I was at the Treasury, I was asked to give the luncheon speech before an audience of 1,000 people at a session of the New England Tax Institute in Boston, and Erwin Griswold, then the Solicitor General of the United States, was scheduled to introduce me. I was to talk for thirty minutes beginning at 1:45 and was cautioned that I must end by 2:15 because of the afternoon program schedule. At 1:40 Erwin rose for the introduction. He did not finish his introduction until 2:12, leaving me three minutes for my thirty minute speech. Of course, I threw away my prepared speech and offered only a few light remarks. Fortunately I was invited back to speak to the New England Tax Institute two years later and was able to thank them for allowing me my remaining twenty-seven minutes.

On another occasion Boris was one of my hosts when I was invited to participate in a panel at the Yale Law School during their annual alumni meeting in the Spring of 1964. Following the panel discussion there was a luncheon for the alumni and guests that commenced at 12:30. In due time Dean Rostow rose to speak and eventually introduce each of the four Yale Law School graduates then serving on the Supreme Court of the United States. Each of them felt called upon to speak, some at length, and it was not until quarter to four o'clock that William Scranton, Governor of Pennsylvania and a Yale alumnus, rose to deliver the main luncheon address. He too threw away his prepared speech but did take the time to announce he was a candidate for the Republican nomination for the Presidency of the United States.

As many of you know, I have also been accused of speaking at length. (Indeed, my students have commemorated this by giving me a T-shirt with "Fast Eddie" emblazoned on the back.) My favorite illustration of this tendency is my calling on one of my students in a class at Virginia to explain a case that had been assigned for reading and hearing him respond, "Professor Cohen, you may not believe this, but I have fallen further behind in this course than you have." That student is now a successful partner in a Washington law firm.

I assure you that in my later years I have reformed, and I propose now to demonstrate my improvement.

I.

First, I would like to say a brief word in response to the latter part of Mike's review. For most of the article, he displays his customary light hearted wit and humor, filled with a barb here and there, but in the latter part he maintains that today a person could not have the kind of career I followed, moving in and out of practice, teaching, and government service, and frequently working in areas outside the tax law. He argues that Congressional staffs have become so enlarged and Congress has otherwise changed to such an extent as to weaken the influence of the Assistant Secretary for Tax Policy on legislation; that law firms, having an eye on the bottom line, do not like their partners engaging in teaching; and that in academia law faculties do not welcome teachers with practical experience in the law. And he is concerned that the growing complexity of the tax law is forcing lawyers, particularly tax lawyers, to specialize to an ever increasing extent.

Mike acknowledges in his review that I do not share his conclusion. Indeed, I wrote the book, as I said in the preface, primarily to establish that a career in the tax field can be intensely interesting and filled with drama and humor. I wanted to express my gratitude for the many unexpected opportunities my work in taxes has afforded me and for the many able, distinguished, and delightful people it has enabled me to know.

I do not hesitate to recommend a career in tax work to those who are young and intrigued by the subject. Indeed I have pointed out to Mike that his own career tends to counter most of his concerns, as do those of others, such as Hank Gutman and Sam Thompson in his own generation.

Mike's concerns are present in so many other areas, such as science, medicine, environment, and even sports. New discoveries, derived from the Hubbell telescope and other instruments, are constantly changing the astronomer's analysis of the heavens, and the almost daily announcements of advances in gene therapy require scientists and doctors to retrain themselves. If we think the tax law is too complicated, we must have been amused to watch the huddles between football officials in recent games when they were befuddled by the complex rules that determine penalties. And I was intrigued by the comment of the Australian who has been retained by the crew of the French challenger in the upcoming America's Cup races to interpret for them the complex rules that govern the competition. He said, "Rule books in the America's Cup look like the bloody Manhattan telephone book." I laughed at this observation, because several days earlier I had introduced my Tax Policy seminar students to the IRS

Statistics of Income and urged them not to be frightened just because it read like the pages of the Manhattan telephone book. All you math students will recognize this proof that a career in the tax law is no more difficult than sailing in the America's Cup. Or officiating in a football game. Rules are complicated and, fortunately for us, lawyers are frequently needed to interpret them.

II.

Nonetheless the members of the bar must bend every effort to prevent the tax system from becoming further complicated. In my book I tell of my early days just out of law school when I reported to Sullivan & Cromwell on Wall Street. On my second day my boss, Norris Darrell, later the president of the American Law Institute, handed me a copy of a reprint of the Revenue Act of 1936, which had just become law and contained the entire federal income tax law at the time, as well as the federal estate and gift tax law, all in one hundred pages. And here it is, dog-eared but well preserved, nearly sixty years later. He said, "Read this and come back when you've finished."

I read the material carefully twice, annotating it as I went along, and three days later I reported back. Norris reached behind him to his bookcase and took out a 400 page book containing all the regulations under the Revenue Act of 1934. Handing the book to me, he said, "Now read this." A week later I returned, having read the entire income tax regulations, and he remarked, "Good. Now you're ready to go to work."

I have told this story many times to my classes and have advised them that if anyone instructed them today to read the entire Internal Revenue Code and the several volumes of regulations they should quit immediately and instead dig ditches for a living.

While it is no surprise that this material has increased in size, we should do our best to slow the vast expansion that has occurred in recent years. I am appalled at the extent to which the Congress in the last two decades has thrust upon the Treasury and the IRS a maze of new responsibilities unrelated to the collection of revenue. As an example, IRS has been required to collect orders for child support from reluctant parents. As another example, the refundable child care credit, which was enacted in the 1970s to relieve low income wage earners from the burden of the social security tax, has been extended so as to grant refunds in amounts well beyond any federal tax they have paid. The result in many cases is that, within some limits, the more income a low-income wage earner reports, the greater is the so-called "refund" from the IRS to the individual.

The IRS is not well equipped by its training and experience to see that individuals do not improperly report more income than they receive. So-called "refunds" that go beyond taxes paid are in reality welfare payments and, I suggest, ought to be administered by welfare agencies rather than by the nation's revenue system.

This trend seems to be evident in some of the proposals now pending before Congress. For example, both the White House and the Republican majority in the House have favored a $500 tax credit for each child, although there are apparently some differences in the parameters of the two versions. The introduction of a new tax credit in addition to the present personal exemption deduction for each child, with different eligibility requirements and different phase-outs, seems likely to complicate the tax returns as well as the instructions and the regulations. For example grandchildren could qualify for the credit but not the exemption, yet college students over age 18 could qualify for the exemption but not the credit. Can one imagine the difficulty of the IRS personnel attempting to answer telephone inquiries as to the differences in eligibility requirements between the child credit and the child personal exemption?

Will not someone speak up for simplicity?

Couldn't we have either a child tax credit or an enlarged child personal exemption, rather than having both with different rules for each, or make a simple change in the tax rates for the so-called middle class?

III.

I would emphasize still another proposal pending in H.R. 9, the Republican package introduced early in January, that I think would cause a major increase in complexity. That is the provision that would introduce indexing of the basis of certain assets to provide an inflation adjustment in determining capital gains and losses on sales of common stocks, real estate, and certain tangible personal property. For example, if one bought common stock or real estate for $100, held it for five years during which time the inflation amounted to 20 percent, and sold the stock then for $120, there would be no taxable gain because the basis of the stock would be indexed upward by 20 percent to adjust for inflation. By contrast, without indexing for inflation under present law there would be a taxable gain of $20. Under the pending proposal if the stock were sold for $125, there would be a taxable gain of only $5 whereas today the gain would be $25.

While there are arguments in favor of providing inflation adjustments to the basis of assets, I concluded some years ago when the proposal was first advanced that it would introduce major new complexities and would involve serious problems which have not yet been solved, if ever they could be solved. I think the bar should caution the Congress about these obstacles before it is too late. Let me illustrate as briefly as possible some of the problems.

Perhaps the first is administrative. Each separate purchase of an asset would require a separate adjustment for inflation. Those who participate in quarterly dividend reinvestment programs maintained by many corporations would have to make a separate inflation adjustment for each quarterly acquisition of shares, even if they are all sold in a single transaction. On a sale at the end of five years twenty different calculations of inflation adjustment would be needed. In the case of monthly mutual fund reinvestment programs, there would be at least sixty calculations at the end of five years. Portfolio statements from brokers and custodians would probably have to reflect not only the cost and value of each separate investment without inflation adjustment but also with the adjustment, because taxpayers might wish to know how to offset a loss against an inflation adjusted gain.

But those problems are largely administrative. There are more substantive issues. It will be noticed that the adjustment for inflation would not apply to debt instruments. While investors in common stocks and real estate would be entitled to inflation adjustment, those who put their money in U.S. government bonds or corporate bonds, or in bank savings accounts or money market mutual funds, would get no adjustment for inflation. Yet the person who invests in debt obligations and collects the principal amounts at maturity suffers the ravages of inflation just as much as the investor in common stock and real estate.

I think it would not be long before those who put their money in savings accounts and government or corporate bonds would realize that they have been discriminated against compared to those who own common stocks and real estate, and they would clamor for equal treatment. But trying to apply indexing to debt instruments has its own set of severe problems. Indexing a $10,000 Treasury ten-year bond for inflation, that may well amount to as much as 40 percent in a decade, would raise the investor's basis for the bond from $10,000 to $14,000 at maturity and produce a capital loss of $4,000. But that would produce a capital loss while the investor would have paid ordinary income tax on the interest received during the decade.

Trying to design a system of adjusting for inflation the amount of taxable interest income proves to be a daunting task. The Treasury attempted it in its initial recommendations to the President for tax reform in

1984 but then withdrew the proposal because of manifold complications. And for similar reasons the indexing proposal in H.R. 9 does not attempt to index debt instruments or the interest paid on them.

While H.R. 9 declines to index for lenders, at the same time it could create a bonanza for borrowers. Take the case of the person who buys real estate for $100,000, putting up $20,000 of her own money and financing the rest on a $80,000 mortgage. After five years, when inflation has accumulated to 20 percent, she sells the property for $120,000. With her original cost indexed upward to $120,000 she has no taxable gain. But after receiving $120,000 on the sale and using $80,000 to pay off the mortgage, she has $40,000 left after investing only $20,000--a gain of 100 percent but with no tax payable. This is because it is the tax basis of $100,000 that is indexed upward and not the amount of her own out-of-pocket investment. In fact it was the mortgagee who suffered from inflation more than the owner of the real estate.

You will recall the case of Mrs. Beulah B. Crane in which the IRS scored a famous Pyrrhic victory. Mrs. Crane inherited an apartment house from her husband worth about $250,000, subject to a mortgage in the same amount for which she had no personal liability. Her tax basis for the property, the IRS and the Supreme Court held, included the amount of the mortgage, though she herself had invested no money; and when she finally deeded the property to the holder of the mortgage, the amount of the nonrecourse mortgage was considered part of her proceeds of sale. She would surely smile at the new indexing proposal because she would be able to index her tax basis, including the mortgage for which she had no responsibility. Thus a person who buys real estate for $100,000, and arranges a nonrecourse mortgage for the entire purchase price, would be entitled to index the $100,000 basis although she has no personal liability and bears no exposure to inflation.

If we are to index for inflation I do not think it can be done fairly unless the indexing adjustment corresponds to the risk of inflation borne by the taxpayer. Applying the indexing to the technical tax basis of property and to the period from the commencement of the technical holding period to its ending, and doing so without regard to whether it measures the risk of inflation to the taxpayer, will provide opportunities for maneuvers that lawyers and other advisors will readily discover. Various types of delayed closings, contingent purchase prices, installment sales, property exchanges and other arrangements present serious problems that are not adequately dealt with in the bill.

I gave a brief luncheon talk on this subject of indexing in 1989 to the New York State Bar Association Section of Taxation when a somewhat similar bill was pending in the Congress and urged them to study the indexing proposal and issue a report. They did in fact do so and in June 1990 issued a detailed analysis. They concluded:

It is our position that the implementation of any indexation system as a part of a modification of the present tax system would be highly inadvisable. While this report is intended to discuss only some of the potential problems with any indexing system, we believe it clearly identifies the nature of the numerous distortion, complexity, and tax arbitrage issues that any indexation system would create.

. . . We are seriously concerned that any indexation system will permit the use of these distortions and tax arbitrage opportunities to seriously erode the revenue base.

I heartily agree with this assessment. The New York Bar report goes into much greater detail and discusses many more problems than I have endeavored here to discuss briefly. It concludes that whether debt is indexed or not, adjustments for inflation create so many complex problems, requiring so many complex rules, that it must not be attempted. And it outlines a variety of possibilities by which investors can produce results that cause unjustifiable revenue losses to the Treasury.

I am happy to note that the Treasury has opposed the indexing proposal, and the New York State Bar Association has also renewed its firm opposition. But the Treasury has also expressed concern with a companion provision in the bill that would exclude from taxable income one-half of long-term capital gains. It is possible that, in some last minute Congressional compromise, indexing would survive in the final bill.

I might add that the bill also contains a complex new depreciation system that would provide annual adjustments for inflation. Both the Treasury and the New York State Bar report oppose that proposal as well, and I shall not take your time to discuss its problems that seem even greater than indexing basis for gain or loss on sales.

I strongly urge the members of the College and the ABA to make a study of the indexing proposal and issue a report similar to that of the New York State Bar before the Congress acts. This proposal has been strongly advocated by Congressman Bill Archer for some fifteen years, and as the new Chairman of Ways and Means he is in a strong position to accomplish his objective. In my book I describe a meeting in the Cabinet Room with President Nixon in which he suggested a tax change about charitable contributions which we included in a Treasury recommendation to Congress. It was enacted in the 1969 Tax Reform Act without difficulty, and I commented in the book that one way to change the tax law to conform to your own ideas is to get yourself elected President of the United States. Another way may be to stay in Congress long enough to become Chairman of the Ways and Means Committee. So this time the indexing proposal will have strong support. Its serious consequences to the revenue system should be pointed out to the Congress.

IV.

This being my turn at bat, I would like to add one comment about a provision in the indexing proposal that attracted my attention. Since some assets would be indexed and others not, a provision is inserted that if nonindexable property is transferred to another person "and the principal purpose of such transfer is to secure or increase" an inflation adjustment, then the Secretary may disallow part or all such adjustment or increase.

Thirty-five years ago I wrote a paper for the Tulane Tax Institute entitled "Tax Avoidance Purpose as a Statutory Test in Tax Legislation." In the paper I pointed out at some length that I thought this was an unfortunate formula for dealing with contrived transactions to reduce tax liabilities. Learned Hand and many others have pointed out that taxpayers are free to arrange their affairs to reduce their taxes as long as the transactions have business purpose or substance. Taxpayers are free to buy tax-exempt bonds, though reducing taxes may be their principal purpose in making the purchase. Mrs. Gregory, as Judge Hand decided, lost her effort at tax reduction because the transaction, while it complied literally with the reorganization provisions, was not in substance a reorganization. Her motive to reduce taxes was not the turning point. I concluded in my 1959 paper:

The fundamental principles, I submit, should be restated in terms which require simply adequate business justification for the taxpayer's actions. If this be present, the tax structure should be satisfied without our seeking to gauge the extent of his tax consciousness in a hazardous effort to probe his state of mind.

When I arrived at Tulane to give the talk, two other speakers and I were interviewed by a reporter from the New Orleans Times Picayune. I thought the title to my paper, "Tax Avoidance Purpose as a Statutory Test in Tax Legislation," might be too difficult for the reporter, so when he came to me and inquired what my subject would be, I replied that I planned to talk on "Taxing the State of Mind." After a moment he inquired, "Are you in favor of it or against it?"

I responded, "I'm against it." The Times Picayune came out with an article bearing a headline that said, in effect, "New York Attorney Urges Repeal of Tax on State of Mind."

I planned several months ago to revisit that article today in the light of the anti-abuse partnership regulations. But when the final anti-abuse regulations came out at the end of last year, it seemed to me that while the words I dislike were still in the regulations, they had been so circumscribed that I think I should just declare victory and not spend time discussing the issue today. That decision was reinforced when I arrived at University of Miami as a visiting professor a couple of weeks ago and found that my office was to be in Room 269--the section number of one of the granddaddies of tax avoidance purpose provisions in the Internal Revenue Code.

I still adhere to my 1959 paper and I think the tax avoidance purpose rule in the indexing provision is simply an admission that the draftsman justifiably did not know what the proper rule should be.

I thank you so much for inviting me to be with you in Los Angeles today. I believe the last time I came out to give a talk here was in the spring of 1979 when I addressed the Los Angeles Bar Association. I recall the date because a few days earlier Ralph Sampson had just announced that he would sign to play basketball for Virginia. Ralph was the seven-foot four-inch high school player who was sought by every college basketball coach in the country. One of the coaches who lost out remarked that "Ralph Sampson and any four other guys are sure to win the NCAA national championship."

I thought that was my one great basketball opportunity. I promised the Los Angeles Bar that I would be back the following January to play with Sampson and three other guys against UCLA in the Pauley Pavilion. On the average, Sampson and I would have made two great six-foot four-inch point guards.

We never won the NCAA, but it is so very nice to be back here with you fifteen years later.

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