Safe Harbors in Tax Law

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Emily Cauble*

Safe harbors pervade tax law. Yet, the academic literature offers no comprehensive account of why they exist. This Article begins to fashion that account by developing a theoretical framework for understanding the functional purposes that safe harbors serve. In order to analyze safe harbors’ functional purposes, this Article compares and contrasts them with rules and standards.

Articulating the reasons for adopting safe harbors has important practical implications. For instance, analyzing the functions of safe harbors can shed light on the use of other rule-standard hybrids such as rebuttable or irrebuttable presumptions. In addition, this Article provides direction to lawmakers considering the enactment or redesign of a particular safe harbor. For example, recently commentators have advocated for additional clarity in the area of law governing tax-exempt organization’s political campaign activities. The analysis in this Article has important implications for the manner in which lawmakers ought to provide any such additional clarity.

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INTRODUCTION

This Article develops a conceptual framework for understanding the functional purposes served by safe harbors in tax law. Tax law consists of bright line rules, fuzzy standards and everything in between. A “rule” specifies, clearly and in advance, the tax consequences resulting from various activities.¹ A “standard” provides only limited guidance to taxpayers before they act, deferring definitive determinations of tax consequences to after-the-fact analysis by the IRS and courts.² Safe harbors represent one example of a type of tax provision in between the extreme ends of the rule-standard spectrum, possessed of some rule-like characteristics and some standard-like characteristics.³ If a taxpayer meets the typically clear requirements of a given safe harbor, the law assures the taxpayer of receiving specific, generally favorable tax treatment.⁴ Thus, a safe harbor has rule-like qualities. If a taxpayer operates outside the boundaries of a safe harbor, he or she will not automatically forfeit the tax treatment accorded to taxpayers falling within the safe harbor. Rather, an underlying standard will determine the tax consequences imposed upon taxpayers who function beyond the limits of a safe harbor, and, under this standard, some taxpayers will receive the same treatment provided to taxpayers within the safe harbor while some will not. Consequently, safe

¹ See, e.g., Louis Kaplow, Rules Versus Standards: An Economic Analysis, 42 Duke L.J. 557, 560 (1992) [hereinafter, Kaplow, Rules Versus Standards] ("This Article will adopt such a definition, in which the only distinction between rules and standards is the extent to which efforts to give content to the law are undertaken before or after individuals act."). See, also, Alice G. Abreu & Richard K. Greenstein, Defining Income, 11 Fla. Tax Rev. 295, 330 (2011) ("A rule...is formal, and in the great majority of circumstances the rule either clearly applies or clearly does not.")

² Kaplow, Rules Versus Standards, supra note 1 at 560; Abreu & Greenstein, supra note 1 at 330 ("Application of a standard tends to be contextual and fact sensitive.")

³ Safe harbors are not the only rule-standard hybrids as discussed below in Part III.

⁴ Because taxpayers vary in a number of respects, a tax outcome that is favorable for one taxpayer could be unfavorable for a different taxpayer. Thus, a provision that operates as a safe harbor with respect to some taxpayers will not necessarily operate as a safe harbor with respect to all taxpayers. As a result, this Article’s discussion of any provision as a safe harbor applies only to the group of taxpayers for whom the outcome mandated by the provision is favorable. In addition, as discussed below, even a taxpayer who meets the requirements of a safe harbor might not receive the specified tax treatment if the IRS invokes generally applicable doctrines and anti-abuse rules to challenge the taxpayer’s claimed tax consequences. See infra note 63 and accompanying text.
harbors preserve standard-like features of tax law. Given its rule-like and standard-like qualities, a safe harbor represents a rule-standard hybrid.

To put these observations in context, consider the treatment of home sales. In some cases, in order to obtain favorable tax treatment, a taxpayer must establish that he or she sold a home because of a change in his or her place of employment.\(^5\) Tax law could utilize a bright line rule to make this determination. A rule might provide that the primary reason for a home sale would be deemed to be a change of place of employment if and only if the taxpayer obtained a new job while he or she owned the previous home and the new place of employment was at least 50 miles farther from the old home than was the previous place of employment. At the other extreme, tax law could make this determination under a vague standard. A standard might provide that the analysis of the primary reason for a home sale would be based on all relevant facts and circumstances.

Currently, tax law uses neither a pure rule nor a pure standard,\(^6\) but, instead, contains a safe harbor that is a hybrid of both approaches. In particular, a safe harbor provides that the primary reason for a home sale is deemed to be a change of place of employment if the taxpayer obtained a new job located at least 50 miles farther from the old home than was the taxpayer’s previous place of employment.\(^7\) However, because this provision is a safe harbor rather than a bright line rule, it is accompanied by an underlying standard so that, if a taxpayer does not meet its requirements, he or she does not necessarily lose the opportunity to demonstrate that a new employment location was the driving force behind a home sale.\(^8\) Rather, in such a situation, the IRS and the courts determine the taxpayer’s primary reason for the sale based on all relevant facts and circumstances, such as the timing of the change of employment relative to the timing of the sale and whether the old home is materially less suitable

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\(^5\) A taxpayer would need to show this in order to exclude from income a portion of the gain from sale of the taxpayer’s home in some cases. See I.R.C. §§ 121(c)(1) and 121(c)(2).

\(^6\) The remainder of this Article will use the term “rule” to describe a pure rule – in other words, a rule that is not associated with a safe harbor. Likewise, it will use the term “standard” to describe a pure standard that is unaccompanied by a safe harbor.

\(^7\) See Treas. Reg. § 1.121-3(c)(2). A taxpayer who has no previous place of employment can qualify for the safe harbor if the distance between the taxpayer’s new place of employment and previous home is at least 50 miles. Id.

\(^8\) See Treas. Reg. § 1.121-3(b).
given the change in place of employment. More generally, a “safe harbor” has two defining features. First, if a taxpayer meets the requirements of the safe harbor, the taxpayer is assured of receiving specific, generally favorable tax treatment. Second, if a taxpayer fails to meet the requirements of the safe harbor, an underlying standard will determine his or her tax consequences, and, under this standard, he or she will not necessarily fail to obtain the same tax consequences that follow from meeting the safe harbor’s requirements.

While safe harbors are not unique to tax law, they appear regularly in the statutes, regulations, and other forms of guidance issued by tax authorities. However, the academic literature lacks any thorough discussion of safe harbors. Given the frequency of safe harbors in tax law, this gap in the literature ought to be addressed. This Article begins to address the existing gap by providing a theoretical framework for understanding the functional purposes of safe harbors.

9 Id.
10 Because taxpayers vary in many respects, an outcome that is desirable for one taxpayer may not be desirable for another taxpayer. Thus, for some taxpayers, the outcome of complying with a safe harbor will be favorable, but, for other taxpayers, the outcome dictated by compliance with the same provision could be unfavorable. For the former group of taxpayers, the provision operates as a safe harbor, but, for the latter group, the provision does not operate as a safe harbor. This Article’s discussion focuses on the former group of taxpayers.

11 Existing articles do generally discuss the idea that safe harbors can provide certainty to taxpayers or briefly mention other potential virtues of safe harbors. This Article, however, provides a theoretical framework for understanding the functional purposes of safe harbors. For an example of an article that discusses the certainty provided by safe harbors, see, Linda M. Beale, Book-Tax Conformity and the Corporate Tax Shelter Debate: Assessing the Proposed Section 475 Mark-to-Market Safe Harbor, 24 V A. TAX REV. 301, footnote 17 (2004) (“Safe harbors seldom draw scholarly comment, but they are a frequent feature of tax provisions. They are generally considered helpful because they facilitate tax administration and reduce taxpayer controversies.”) For an article that discusses another potential virtue of safe harbors, see, e.g., Saul Levmore, Double Blind Lawmaking and Other Comments on Formalism in the Tax Law, 66 U. CHI. L. REV. 915, 920 (1999).

12 This Article focuses on the functional purposes of safe harbors because the analysis of functional purposes is most relevant to addressing the question of whether, as a policy matter, a given safe harbor should exist or how a safe harbor should be designed. Functional purposes, however, do not fully explain why, as a practical matter, any particular safe harbor exists. Lawmakers may enact particular safe harbors for a number of reasons. For instance, lawmakers may adopt safe harbors when taxpayers advocate for their inclusion in tax guidance. In addition, lawmakers may adopt safe harbors in
Given that a safe harbor is a rule-standard hybrid, this Article assesses whether safe harbors offer any advantages over rules and standards. Specifically, this Article suggests and evaluates four potential advantages. First, compared to standards, safe harbors provide additional certainty. However, as others have observed, certainty in tax law is not an unambiguously desirable feature -- it furthers some goals but undermines others. Furthermore, as this Article demonstrates, rules are better suited than safe harbors to enhancing certainty in a way that maximizes its benefits. Second, although rules may be preferable to safe harbors when certainty is the dominant consideration, safe harbors may be less arbitrary than rules. Third, safe harbors are more forgiving than rules, less likely than rules to trap unwary taxpayers, and, consequently, more equipped than rules to serve the goal of fairness. Fourth, compared to rules or standards, safe harbors may be less likely to distort taxpayers' decision making in certain types of cases (but not in all cases).

Analyzing the underlying rationales for safe harbors is a useful exercise because it sheds light on the use of other rule-standard hybrids, such as rebuttable or irrebuttable presumptions. Furthermore, examining the underlying reasons for adopting safe harbors provides direction to lawmakers considering the enactment or redesign of a particular safe harbor. To take a timely example, recently the popular press has focused heightened attention on tax law's provisions regarding tax-exempt entities' political activities. An entity that is exempt from tax under section 501(c)(3) of the Internal Revenue Code risks losing its tax exemption if it "participate[s] in, or intervene[s] in...any campaign on behalf of (or in response to the perceived failure of existing rules or standards.

One might ask whether, as a practical matter, a safe harbor differs from a rule. The answer depends on how permissive or restrictive the safe harbor is. See infra Part II.D. Furthermore, as discussed below, many partnerships operate outside the substantial economic effect safe harbor governing partnership tax allocations, and such partnerships view it as a safe harbor rather than merely a rule. See infra note 127. In addition, it is not difficult to imagine situations in which a home sale would fail to qualify for the 50 mile safe harbor but, nevertheless, be treated as motivated primarily by a change in place of employment. For example, a taxpayer may receive a job offer that requires the taxpayer to live in a different location that is less than 50 miles from the taxpayer's previous job. Perhaps the taxpayer obtains a job working for a governmental unit and is required to live within the government's jurisdiction which is located 10 miles away from the taxpayer's current job.

See infra Part II.A.2.

See, e.g., Floyd Norris, A Fine Line Between Social and Political, NEW YORK TIMES (May 17, 2013); Stephanie Strom, The Political Pulpit, NEW YORK TIMES (October 1, 2011).
opposition to) any candidate for political office.”

Under current law, whether an entity is improperly engaged in campaign activity is determined under a standard. Commentators have called for additional clarity in this area of law. Some reform proposals entail the adoption of clear rules, and others rely on safe harbors. The analysis in this Article has important implications for the shape that any such reform should take.

This Article proceeds as follows. Part I describes safe harbors in more detail and provides two examples of safe harbors in tax law that will be used to illustrate observations made in the remainder of the Article. Part II suggests and evaluates the potential benefits of safe harbors, compared to rules and standards. Part III describes other rule-standard hybrids. Part IV discusses reform implications of the analysis in the Article.

I. SAFE HARBORS IN TAX LAW: PROTECTING TAXPAYERS FROM THE VAST UNKNOWN OF FACTS AND CIRCUMSTANCES TESTS

Numerous areas of tax law use tests based on the facts and circumstances of a particular case. These facts and circumstances tests are frequently vague for the taxpayers who confront them. Oftentimes, a safe harbor accompanies such a facts and circumstances test. If a taxpayer satisfies the safe harbor’s clearly defined criteria, the taxpayer will receive specific, generally favorable, tax treatment and need not evaluate how he or she would fare under the facts and circumstances test. If a taxpayer operates outside the boundaries of a safe harbor, he or she will not automatically forfeit the tax treatment accorded to taxpayers falling within

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16 I.R.C. Section 501(c)(3).
17 For further discussion, see, e.g., Ellen P. Aprill, Why The IRS Should Want to Develop Rules Regarding Charities and Politics, 62 CASE W. RES. L. REV. 643, 645 and 651 – 54 (2012).
19 See, e.g., Aprill, supra note 17 at 680 (discussing the adoption of clear rules and the use of safe harbors); Guinane, supra note 18 at 155 – 66 (discussing the adoption of a bright line rule); Id. at 168 – 69 (discussing rules and safe harbors); Kingsley, supra note 18 at 38 (discussing both possibilities).
20 However, as discussed below, even a taxpayer who meets the requirements of a safe harbor might not receive the specified tax treatment if the IRS invokes generally applicable doctrines and anti-abuse rules to challenge the taxpayer’s claimed tax consequences. See infra note 63 and accompanying text.
the safe harbor. Rather, an underlying standard will determine the tax consequences imposed upon taxpayers who function beyond the limits of a safe harbor, and, under this standard, some taxpayers will receive the same treatment provided to taxpayers within the safe harbor while some will not.

Safe harbors vary in terms of their source. Some are embodied in the Internal Revenue Code, others in Treasury Regulations, and still others in Revenue Procedures and other forms of guidance issued by taxing authorities.

Safe harbors also vary in terms of design. Some safe harbors may be designed so that they are very permissive, while others are quite restrictive. This Article refers to a safe harbor as “permissive” when its outer bounds approach the likely outer bounds of the underlying standard, and this Article labels a safe harbor as “restrictive” when its outer bounds lie well within the likely outer bounds of the underlying standard. A very permissive safe harbor functions as a de facto rule because a taxpayer who operates outside such a safe harbor will almost certainly receive tax treatment that differs from the treatment of taxpayers within the safe harbor, which is the same result that follows the failure to comply with a rule. A very restrictive safe harbor operates as a de facto standard because it provides the taxpayer with little more information than what the taxpayer would have if he or she were confronted with a standard.

In order to demonstrate, consider the example of speed limits. In

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21 For example, when a corporation redeems stock owned by a shareholder, if the shareholder would benefit from treating the redemption as a sale of the stock rather than a Section 301 distribution, Sections 302(b)(2) and 302(b)(3) contain safe harbors. If the shareholder meets the requirements of these provisions, the shareholder is assured of receiving sale or exchange treatment. I.R.C. §§ 302(a), 302(b)(2), 302(b)(3). If the shareholder does not meet these requirements, the shareholder still has a chance of receiving sale or exchange treatment under the vague, underlying standard contained in Section 302(b)(1). The safe harbors under which an individual is treated as a non-U.S. person are also contained in the Internal Revenue Code. See infra Part I.B.1.

22 For example, the safe harbor regarding home sales mentioned above is contained in Treasury Regulations. See supra notes 7 to 9 and accompanying text. The safe harbors under which partnerships are treated as non-publicly-traded are also contained in Treasury Regulations. See infra Part I.A.1.

23 For example, Rev. Proc. 93-27 contains a safe harbor. See infra note 87.

24 This example has been invoked by scholars to distinguish between rules and standards. See, e.g., Kaplow, Rules Versus Standards, supra note 1 at 560.
the context of speed limits, a standard might provide that individuals driving on a highway cannot drive at a speed that would be unsafe given the current driving conditions. A rule might provide that individuals driving on a highway cannot drive in excess of 75 miles per hour. A safe harbor could provide that an individual who is not driving in excess of X miles per hour cannot be fined for speeding, and an individual who does drive in excess of X miles per hour will only be fined for speeding if he or she is driving at an excessive speed that is unsafe given current driving conditions. Depending on the number assigned to X, the safe harbor could be more permissive or more restrictive. If X is 30 miles per hour, the safe harbor is very restrictive. Even if drivers were presented with merely the underlying standard -- “no driving at excessive speeds that are unsafe” -- they would surmise that they could drive 30 miles per hour without being fined. Thus, a very restrictive safe harbor provides little additional information than the information provided by the underlying standard, and, as a result, a very restrictive safe harbor acts as a de facto standard. If X were 80 miles per hour, the safe harbor would be very permissive. Drivers would assume that, if they drove in excess of 80 miles per hour, their driving speed would, very likely, be deemed unsafe based on the underlying standard. As a result, the 80 miles per hour safe harbor, like permissive safe harbors generally, operates as a de facto rule. Just as a speed limit safe harbor could be more restrictive or more permissive, tax law safe harbors vary along this dimension as well, and this design feature of a tax law safe harbor affects how similar the safe harbor is to a rule or a standard.

Another design feature of a safe harbor also affects how comparable it is to a rule or a standard. In particular, the outer limit of a safe harbor may, itself, be more rule-like or more standard-like. In the speed limit safe harbor example, the outer limit of the safe harbor is a clearly defined rule. Some safe harbors in tax law are also demarcated by clearly defined rules but others are not.

Finally, safe harbors differ in terms of the type of affected taxpayer.

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25 For example, the outer bounds of the safe harbors described in Parts I.A and I.B below are fairly clear.

26 For example, to meet the safe harbor in Rev. Proc. 93-27, a profits interest cannot relate “to a substantially certain and predictable stream of income from partnership assets, such as income from high-quality debt securities or a high-quality net lease”. This requirement is not clearly defined.
For instance, some safe harbors govern the tax treatment of individual taxpayers\textsuperscript{27} while others apply in the business context.\textsuperscript{28}

This Part will describe two particular safe harbors – one that applies in the business context and one that affects individual taxpayers. These examples are provided so that they may be used to illustrate issues discussed in the remainder of the Article. The first safe harbor determines entity classification, and the second safe harbor governs the classification of individuals as U.S. persons for tax purposes.

A. Entity Classification: When is a Partnership Publicly Traded?

The tax consequences imposed upon a business entity and its owners vary greatly depending on how the business entity is classified for tax purposes. If an entity is treated as a corporation for tax purposes, generally the entity will be subject to entity-level tax.\textsuperscript{29} Furthermore, owners of the entity may be subject to tax when they sell ownership interests in the entity or receive certain distributions from it.\textsuperscript{30} If it is treated as a partnership for tax purposes, an entity will not be subject to tax. Instead, any items of tax income, gain, loss or deduction recognized by the entity will be passed through to the entity’s owners to take into account directly when computing their own taxable income.\textsuperscript{31} Thus, treatment as a corporation generally necessitates two levels of tax, both an entity-level tax and an owner-level tax.\textsuperscript{32} By contrast, treatment as a partnership entails only one level of tax, the tax imposed at the owner level.\textsuperscript{33}

Although many business entities can elect to be treated as partnerships or corporations for tax purposes, certain entities must be

\textsuperscript{27} For example, see infra Part I.B.1 (discussing safe harbors under which an individual is treated as a non-U.S. person) and see supra notes 7 to 9 and accompanying text (discussing safe harbors related to the tax treatment of home sales).

\textsuperscript{28} For example, see infra Part I.A.1 (discussing the safe harbors under which partnerships are treated as non-publicly-traded).

\textsuperscript{29} I.R.C. § 11. The discussion in the text assumes that the corporation is a “C corporation” and not an “S Corporation”.

\textsuperscript{30} I.R.C. § 301 (regarding distributions), I.R.C. § 1001 (regarding gain from sale of ownership interests).

\textsuperscript{31} I.R.C. § 701.

\textsuperscript{32} See supra notes 29 and 30 accompanying text.

\textsuperscript{33} See supra note 31 and accompanying text.
treated as corporations. For example, a publicly-traded partnership must be treated as a corporation for tax purposes unless it earns predominately certain types of passive income.

Some partnerships comply with safe harbors assuring those partnerships that they are not publicly traded. Other partnerships run afoul of a rule classifying those partnerships as publicly traded. A standard governs the treatment of partnerships that are not covered by the safe harbors or the rule.

1. The Safe Harbors That Guarantee Non-Publicly-Traded Treatment

Current law assures a partnership that it will receive non-publicly-traded treatment if interests in the partnership are not traded on an established securities market and the partnership complies with either the private placement safe harbor or the lack of actual trading safe harbor. The private placement safe harbor applies to a partnership if interests in the partnership are issued in a transaction that need not be registered under the Securities Act of 1933 and the partnership does not have more than 100 partners at any time. A partnership resides within the lack of actual trading safe harbor if not more than two percent of the total interests in partnership capital or profits are transferred during any given year. Meeting the requirements of either safe harbor protects a partnership from publicly-traded status, and such a partnership retains the flexibility to elect its desired entity classification.

34 Treas. Reg. § 301.7701-3(a) (providing ability to elect tax classification to many entities); Treas. Reg. §§ 301.7701-2(b)(1), 301.7701-2(b)(3) – (8) (describing entities that must be treated as corporations).

35 I.R.C. §§ 7704(a), 7704(c), and 7704(d).

36 A “publicly-traded partnership” means a partnership the interests in which are either (1) “traded on an established securities market” or (2) “readily tradable on a secondary market (or the substantial equivalent thereof).” I.R.C. § 7704(b). A partnership will not be considered “readily tradable on a secondary market (or the substantial equivalent thereof)” if it complies with one of the safe harbors. See Treas. Reg. §§ 1.7704-1(h) and 1.7704-1(j).

37 See Treas. Reg. § 1.7704-1(h).

38 See Treas. Reg. § 1.7704-1(j).
2. The Dangerous Cliff: A Rule That Mandates Publicly-Traded Treatment

A partnership is publicly traded if interests in it are traded on an established securities market. Consequently, if the interests in a partnership were traded on the New York Stock Exchange, for example, the partnership would be publicly traded. Once a partnership crosses this threshold, it loses all hope of classification as a partnership for tax purposes unless most of its earnings consist of certain types of passive income.

3. The Vast Unknown in Between: Facts and Circumstances Related to Extent of Trading

If a partnership is not traded on an exchange and does not meet the requirements of one of the safe harbors, a vague, facts and circumstances test will establish its tax treatment. In particular, the partnership will be deemed to be publicly traded if, given all the facts and circumstances, partners are readily able to buy, sell or exchange their partnership interests in a manner that is economically comparable to trading on an established securities market. The Treasury Regulations specifically provide that a partnership’s failure to qualify for a safe harbor will not automatically result in its treatment as a publicly-traded partnership. To provide some guidance, the Treasury Regulations list factors that must be considered when assessing the partnership under this all facts and circumstances test. These factors include, among others: (1) whether interests in the partnership are regularly quoted by a broker, dealer or other person making a market in the interests and (2) whether prospective buyers and sellers otherwise have readily available, regular, and ongoing opportunities to buy, sell or exchange interests in the partnership.

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39 I.R.C. § 7704(b).
40 See Treas. Reg. § 1.7704-1(b).
41 See Treas. Reg. § 1.7704-1(c).
42 See Treas. Reg. § 1.7704-1(c)(3).
43 See Treas. Reg. § 1.7704-1(c)(2).
44 Id. Transfers that are not recognized by the partnership and certain other transfers will be disregarded when determining whether the partnership is publicly traded. See Treas. Reg. §§ 1.7704-1(d), 1.7704-1(e).
B. Determining Whether an Individual is a U.S. Person for Tax Purposes

A second example of a safe harbor exists in the provisions governing whether an individual is treated as a U.S. person for tax purposes. If an individual is a U.S. person for tax purposes, he or she will be subject to U.S. income tax on his or her worldwide income. By contrast, an individual who is not a U.S. person for tax purposes generally will be subject to U.S. tax only on income connected with the United States in some way. Thus, treatment as a U.S. person for tax purposes can be less favorable than treatment as a non-U.S. person. In addition to a safe harbor assuring individuals that they are not U.S. persons for tax purposes, the law also provides rules that make clear to individuals that they are U.S. persons for tax purposes. Finally, in some circumstances, an individual will neither meet the requirements of a safe harbor nor be classified automatically as a U.S. person under a rule. In such a case, the individual’s tax status will be determined under a standard.

1. The Safe Harbor That Guarantees Non-U.S. Person Status

An individual will clearly not be a U.S. person for tax purposes if the individual: (1) is not a U.S. citizen,\(^{45}\) (2) was not admitted as a lawful permanent U.S. resident,\(^{46}\) and (3) was physically present in the United States for fewer than a specified number of days during a specified time period.\(^{47}\) Qualifying for this safe harbor provides assurance that the

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\(^{45}\) See I.R.C. § 7701(a)(30)(A) (providing that a U.S. citizen is a U.S. person for tax purposes).

\(^{46}\) See I.R.C. §§ 7701(b)(1)(A)(i) (providing that a lawful permanent resident will be treated as a U.S. resident); 7701(a)(30)(A) (providing that a U.S. resident is a U.S. person for tax purposes).

\(^{47}\) There are two ways that an individual can meet this number-of-days requirement. First, the individual will meet the requirement if he or she was physically present in the United States for fewer than 31 days during the calendar year. See I.R.C. § 7701(b)(3)(A)(i) (providing that an individual cannot meet the substantial presence test – which could make an individual a U.S. resident and therefore a U.S. person for tax purposes – unless the person is present in the United States on at least 31 days during the calendar year). Furthermore, certain days during which the individual is present in the United States will not count. See I.R.C. §§ 7701(b)(3)(D), 7701(b)(7). Second, an individual will meet the number-of-days requirement if he or she was physically present in the United States such that the following equation results in a number less than 183: the days during the current
individual will not be subject to the more expansive U.S. tax rules applicable to U.S. persons.

2. The Dangerous Cliffs: Rules That Mandate U.S. Person Status

There are three ways in which an individual will automatically become a U.S. person for tax purposes in a given calendar year. First, any U.S. citizen will be treated as a U.S. person for tax purposes.\(^{48}\) Second, any individual who has been admitted at any time during the calendar year as a lawful permanent U.S. resident will be treated as a U.S. person for tax purposes.\(^{49}\) Third, any individual who is physically present in the United States on 183 days or more in a given calendar year will be treated as a U.S. person for that year.\(^{50}\) As soon as an individual crosses one of these lines, he or she is a U.S. person and, thus, becomes subject to potentially more burdensome U.S. tax rules.

3. The Vast Unknown In Between: Facts and Circumstances Related to Extent of Contacts

If an individual neither meets the requirements of the safe harbor (which would guarantee non-U.S. person status) nor runs afoul of a rule (which would mandate U.S. person status),\(^{51}\) the individual’s status will be

\[\text{year when the individual was present in the United States plus } \frac{1}{3} \times \text{days during the first preceding year when the individual was present in the United States plus } \frac{1}{6} \times \text{days during the second preceding year when the individual was present in the United States. See I.R.C. § 7701(b)(3)(A)(ii) (providing that an individual cannot meet the substantial presence test – which could make an individual a U.S. resident and therefore a U.S. person for tax purposes – unless the preceding equation yields at least 183 days). Furthermore, certain days during which the individual is present in the United States will not count. See I.R.C. §§ 7701(b)(3)(D), 7701(b)(7).}\]

\(^{48}\) See supra note 45.

\(^{49}\) See supra note 46.

\(^{50}\) Such an individual would meet the substantial presence test that causes an individual to be a U.S. resident and therefore a U.S. person for tax purposes. See I.R.C. § 7701(b)(3)(A). Moreover, given that he or she is actually present in the United States for 183 days or more during the current year, such an individual would not be eligible to show that he or she was not a U.S. person because of a closer connection to another country in which he or she had a tax home. See I.R.C. § 7701(b)(3)(B)(i).

\(^{51}\) An individual falls into this situation if the following four facts are all true. First, the individual is not a U.S. citizen. If he or she were a U.S. citizen, he or she would
uncertain. In such a case, the individual will be treated as a U.S. person for tax purposes unless the individual can establish that he or she has a tax home in a non-U.S. country and has a closer connection to such country than to the United States.\textsuperscript{52} When determining whether an individual has a closer connection to a non-U.S. country than to the United States, all relevant facts and circumstances must be considered, including, among others: (1) the location of the individual’s permanent home, (2) the location of the individual’s family, (3) the location of the individual’s personal belongings, (4) the location of social, political, cultural or religious organizations with which the individual has a current relationship, (5) the location where the individual conducts personal banking activities, and (6) the jurisdiction in which the individual votes.\textsuperscript{53}

II. \textbf{What Benefits Do Safe Harbors Offer?}

\textsuperscript{52} See I.R.C. § 7701(b)(3)(B)(ii). This could be described as setting forth a rebuttable presumption that certain individuals are U.S. persons. A standard determines whether such persons are able to rebut the presumption.

\textsuperscript{53} See Treas. Reg. § 301.7701(b)-2(d).
In lieu of a safe harbor, lawmakers could merely rely on a vague standard or, instead, adopt a bright line rule. Do safe harbors provide any advantages compared to these alternatives? This Article suggests four potential advantages. First, compared to standards, safe harbors provide additional certainty. Second, safe harbors may be less arbitrary than rules. Third, safe harbors are more forgiving than rules, less likely than rules to trap unwary taxpayers, and, consequently, more equipped than rules to serve the goal of fairness. Fourth, compared to rules or standards, safe harbors may be less likely to distort taxpayers’ decision making in certain types of cases (but not in all cases). This part will assess each of these potential advantages, in turn.

A. Safe Harbors Provide Additional Certainty

Compared to standards, safe harbors provided additional certainty. However, as others have observed, certainty in tax law is not a categorically advantageous quality. Furthermore, rules may be better suited than safe harbors to enhancing certainty in a way that maximizes its benefits. This part will proceed as follows. First, it will use the examples in Part I to demonstrate how safe harbors increase certainty. Next, it will discuss whether and why certainty in tax law is desirable. Finally, it will show that, when certainty is the overriding objective, rules may be preferable to safe harbors.

1. How Safe Harbors Increase Certainty

Safe harbors increase certainty. In particular, safe harbors provide taxpayers with reduced risk and reduced ambiguity. When used in the technical sense, “risk” and “ambiguity” refer to distinct concepts. Risk is present whenever the chances that a desirable outcome will occur.

54 See, e.g., Peter P. Swire, Safe Harbors and a Proposal to Improve the Community Reinvestment Act, 79 VA. L. REV. 349, 372 (1993) (discussing safe harbors in law generally and stating, “Compared to a standard-based regime, the chief benefit of a safe harbor is a reduction in uncertainty”).

are less than 100%. Ambiguity results from the fact that the chances that an outcome will occur are not known beyond doubt. Thus, for instance, if the chances of a favorable outcome are 70%, and a person knows that the odds are exactly 70%, risk is present but ambiguity is lacking. If a person believes that a given outcome’s chances of occurring are 70% but does not have complete confidence in this 70% figure, the person experiences both risk and ambiguity. A safe harbor reduces risk and ambiguity for taxpayers who operate within the safe harbor’s parameters. A safe harbor reduces risk for a taxpayer who qualifies for it because the taxpayer’s chances of obtaining a favorable outcome will be 100% (or nearly 100%). A safe harbor also reduces ambiguity because a taxpayer who operates within the bounds of the safe harbor can be quite confident that his or her chances of obtaining a favorable outcome are 100% (or nearly 100%). The reduction in ambiguity results from the taxpayer’s high confidence that he or she has accurately assessed the chances of obtaining a favorable outcome.

In each of the examples described in Part I, the safe harbor reduces risk and ambiguity compared to an alternative system that employed the underlying standard to ascertain tax consequences. Regarding the publicly-traded partnership provisions, under current law, a partnership can rely on various safe harbors that provide assurance that the partnership is not publicly traded. For instance, the lack of actual trading safe harbor applies if not more than two percent of interests in a partnership change hands in a given year. In many cases, a partnership can readily obtain the information necessary to determine whether this safe harbor applies. If the lack of actual trading safe harbor does apply, then the partners can confidently conclude that the partnership will not be treated as publicly traded. Absent safe harbors, tax law might treat partnerships as publicly traded whenever they were listed on a securities exchange and whenever, given all the facts and circumstances, partners

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56 The odds may be less than 100% if the taxpayer’s position could be subject to challenge under overarching doctrines or anti-abuse rules. See infra note 63 and accompanying text.

57 This is only true if the taxpayer’s position is not potentially subject to challenge under overarching doctrines or anti-abuse rules. See infra note 63 and accompanying text. In some cases, factual uncertainty regarding whether a taxpayer complies with a safe harbor’s requirements can create risk and ambiguity. Whether factual uncertainty is likely to arise depends, in part, on how the safe harbor is designed. If a clear, mathematical rule delineates the outer bounds of the safe harbor, factual uncertainty is less likely but, at the same time, the outer bounds of the safe harbor can be more arbitrary. For further discussion of arbitrariness, see infra Part II.B.
were readily able to buy, sell or exchange their partnership interests in a manner economically comparable to trading on an established securities market.\textsuperscript{58} Taxpayers might find it quite difficult to determine whether the second part of this test applied to their partnership even in circumstances in which, under current law, the partnership would qualify for a safe harbor. As a result, taxpayers would face both increased risk (as the probability that the partnership was not publicly traded would be less than 100\%) and increased ambiguity (as the probability that it was not publicly traded would be unknown).

Similarly, current tax law provides assurance that certain individuals will not be treated as U.S. persons for tax purposes. For instance, if an individual is not a U.S. citizen, has not been admitted as a lawful permanent U.S. resident, and was not present in the United States for a specified number of days over a specified time period, he or she will not be a U.S. person for tax purposes.\textsuperscript{59} Instead, tax law could provide that the tax status of an individual would be determined based on all relevant facts and circumstances bearing on the extent of the person’s connections with the United States. This alternative standard would rewind tax law back to the time before 1984 when the tax status of individuals was determined on a case-by-case basis and depended on the extent of a person’s U.S. connections.\textsuperscript{60} Absent safe harbors, individuals would encounter greater risk and ambiguity in cases when their tax status, under current law, would be clear.

Although a safe harbor provides taxpayers with less risk and less ambiguity, these effects should not be overstated. The risk reduction and diminished ambiguity resulting from a safe harbor are limited in four ways. First, a safe harbor supplies a more definite tax result only for taxpayers who qualify for it. By contrast, taxpayers who operate beyond the bounds of a safe harbor continue to face risk and ambiguity.

Second, depending, in part, on how a safe harbor is designed, taxpayers may not always know whether they operate within its bounds. The outer limit of a safe harbor may, itself, be more rule-like or more standard-like. Only in the former case – when the outer border of a safe harbors.

\textsuperscript{58} See supra Part I.A (discussing the publicly-traded partnership rules).
\textsuperscript{59} See supra Part I.B (discussing when an individual is a U.S. person for tax purposes).
\textsuperscript{60} See, e.g., Charles H. Gustafson, Robert J. Peroni, Richard Crawford Pugh, \textit{TAXATION OF INTERNATIONAL TRANSACTIONS} (West 4\textsuperscript{th} ed.) at ¶1185.
harbor is rule-like – will taxpayers easily discern whether they qualify for it.

Third, in an alternative universe in which one of the current tax safe harbors did not exist, case law and additional guidance might develop over time to provide taxpayers with less risk and less ambiguity.61 Thus, any one particular safe harbor might not create significant risk and ambiguity reduction. If a given safe harbor were eliminated, more taxpayers would confront a vague standard, and taxpayers and the IRS would engage in more disputes regarding the standard. Consequently, courts would decide more cases regarding the standard. Furthermore, the IRS might issue additional guidance, such as revenue rulings, in an attempt to increase taxpayer compliance. These revenue rulings might contain new safe harbors.62

Finally, the reduced risk and lessened ambiguity afforded by safe harbors are limited because safe harbors are, in fact, not completely safe. Overarching tax law doctrines and anti-abuse rules might apply, in some cases, when a given transaction technically complies with the literal language of a safe harbor but undermines the purpose of the safe harbor.63 In such a case, the IRS might successfully assert that a taxpayer is

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61 For similar observations regarding standards in law generally, see, e.g., Kaplow, Rules Versus Standards, supra note 1 at 577 – 79 (discussing the possibility that precedent can transform a standard into a rule); Carol M. Rose, Crystals and Mud in Property Law, 40 Stan. L. Rev. 577, 593 (1988) (discussing how property law tends to oscillate between clear rules and vague standards); Pierre J. Schlag, Rules and Standards, 33 UCLA L. Rev. 379, 413 (1985) (“[T]he ‘balancing’ or ‘totality of circumstances’ tests that are often used in constitutional law...viewed in isolation look very flexible. But as soon as we consider how they are applied by judges, it becomes apparent that these tests merely defer the constraints on judicial decision making to some external source such as precedent.”); Cass R. Sunstein, Problems with Rules, 83 Cal. L. Rev. 953, 965 (“Once we define the term ‘excessive’ [in a law prohibiting driving at excessive speeds], we may well end up with a rule.”)

62 For similar discussion of how tax administrators can reduce uncertainty, see, e.g., Osofsky, supra note 55 at 494 – 95.

63 Indeed, in the context of the substantial economic effect safe harbor governing partnership tax allocations, discussed in note 127, the partnership anti-abuse rule specifically provides that it may apply when, “partnership items are allocated in compliance with the literal language of [the partnership tax allocation rules] but with results that are inconsistent with the purpose of [the partnership tax allocation rules].” See Treas. Reg. § 1.701-2(c)(5). A discussion of anti-abuse rules and doctrines is beyond the scope of this Article. Such rules and doctrines include the substance-over-form doctrine, the step transaction doctrine, the economic substance doctrine, and a number of anti-abuse rules applicable to specific areas of tax law such as the partnership anti-
not entitled to his or her claimed tax consequences. For example, as discussed above, the private placement safe harbor provides that a partnership will not be publicly traded if interests in the partnership are issued in a transaction that need not be registered under the Securities Act of 1933 and the partnership does not have more than 100 partners at any time. In the context of this safe harbor, an anti-avoidance rule provides that, in some cases, a person will be counted as a partner even if the person’s interest in a partnership is indirect. For example, assume one partnership (“Lower Tier Partnership”) issues interests that are held by ten separate partnerships (“Upper Tier Partnerships”). Each Upper Tier Partnership holds a 10% interest in the Lower Tier Partnership and no other assets. Each Upper Tier Partnership is owned by 100 individuals. If the taxpayers claim that all partnerships meet the private placement safe harbor, the IRS could challenge this claim and treat the arrangement as involving one partnership with 1000 partners (in other words, the IRS could treat the 1000 individuals as partners in the Lower Tier Partnership).

2. Is Certainty in Tax Law Desirable?

As discussed above, safe harbors can increase certainty. However, certainty in tax law is not, undeniably, a goal worth pursuing. Scholars

\[64\text{ See supra note 37 and accompanying text.}\]

\[65\text{ See Treas. Reg. § 1.7704-1(h)(3).}\]
have written many insightful articles regarding risk and ambiguity in tax law, highlighting some of the benefits of increased certainty as well as some of the dangers. This part will briefly review the debate, discussing, first, the downsides of too much certainty and, second, the dangers of too little certainty.

a. The Downsides of Too Much Certainty

Existing literature expresses some uneasiness about supplying too little risk and too little ambiguity in tax law for at least two reasons. First, some scholars have argued that, when faced with a lack of guidance and, thus, more ambiguity, taxpayers may report higher tax liability, and, as a result, providing additional guidance to lessen ambiguity could result in reduced tax revenue. Other scholars have reached the opposite conclusion, arguing that greater ambiguity could cause taxpayers to report less tax liability.

Second, scholars worry that sophisticated taxpayers and their advisors will use clear rules as a guide for arranging transactions that comply with the letter, but not the spirit, of the rules. Transactions that

66 See, e.g., Suzanne Scotchmer & Joel Slemrod, Randomness in Tax Enforcement, 38 J. PUB. ECON. 17, 17 (1989) (“When there is tax evasion, increased randomness about how much taxable income an auditor would assess generally leads to higher reported income and more revenue.”); Kyle D. Logue, Optimal Tax Compliance and Penalties When the Law Is Uncertain, 27 VA. TAX REV. 241, 250-51 (2007) (“If taxpayers are thought to be risk averse, it is not difficult to imagine how strategically increasing tax law uncertainty...in some contexts could serve the same function as increasing noncompliance penalties directly.”). See, also, Lawsky, Probably?, supra note 55 at 1018 (“[T]he uncertainty associated with whether certain questionable transactions are permitted ...may itself reduce the number of taxpayers who engage in those transactions.”)

67 See, e.g., Ososky, supra note 55.

technically comply with rules can produce unintended tax benefits for these taxpayers because lawmakers who create the rules cannot perfectly predict all transactions that taxpayers will devise once the rules are written. Standards, however, can provide the IRS with the flexibility needed to challenge these unanticipated transactions. Concern about the misuse of clear rules is not necessarily a justification for eliminating safe harbors given that safe harbors are not completely safe. As discussed above, overarching tax law doctrines and anti-abuse rules can apply, in some cases, even when a transaction technically complies with a safe harbor. The IRS could use these anti-abuse rules and doctrines to challenge unanticipated transactions that exploit safe harbors in order to manufacture unintended tax benefits. However, despite the fact that the IRS has at its disposal anti-abuse rules and other doctrines, safe harbors may produce unintended tax benefits because courts are not always receptive to the argument that anti-abuse provisions can override the results that follow from the application of clear rules.


See, e.g., McMahon, supra note 68 at 1722; Weisbach, *Formalism*, supra note 68 at 867-69. Along similar lines, others have observed that legislative intent or purpose is relevant when determining whether a transaction is a tax shelter, is abusive, or otherwise is subject to challenge. See, e.g., Bankman, *Economic Substance*, supra note 63 at 13-15; Joshua D. Blank, *What’s Wrong with Shaming Corporate Tax Abuse*, 62 TAX L. REV. 539, 539 (2009); Lawsky, *Probably?*, supra note 55 at 1032; Lederman, supra note 63 at 396 – 97; Schler, supra note 63 at 331.

See, e.g., Cunningham & Repetti, supra note 68 at 6; Johnson, supra note 68 at 445 (“The court-made equitable doctrines such as substance over form, sham transaction, and step transaction give the law a vigor that helps the law defend against aggressive misinterpretations of the statute to avoid tax”); Monroe, *What’s in a Name*, supra note 68 at 413; Shaviro & Weisbach, supra note 68 at 513; Weisbach, *Formalism*, supra note 68 at 876 (“[I]n crafting a tax law that includes an anti-abuse rule, drafters need not be terribly concerned with rare transactions that might be mistaxed because attempts to take advantage of them will be covered by the anti-abuse rule”).

See supra note 63 and accompanying text.

See, e.g., Marvin A. Chirelstein & Lawrence A. Zelenak, *Tax Shelters and the Search for a Silver Bullet*, 105 COLUM L. REV. 1939, 1939 (2005) (“Recent litigation between taxpayers and the government has had mixed results, with taxpayers winning in more than a few instances by persuading the courts that ‘rules are rules’ and that Congress alone, and not the courts, must patch the leaky tire if Congress thinks a patch is needed.”); David A. Weisbach, *The Failure of Disclosure as an Approach to Shelters*, 54 SMU L. REV. 73, 77 (2001).
b. The Dangers of Too Little Certainty

Although too little risk and too little ambiguity might create undesirable effects, scholars have noted that too much risk and too much ambiguity also can generate harm in at least five ways. First, risk and ambiguity impose heavy compliance burdens on taxpayers who, because of the risk and ambiguity, will not know how to apply the law. Second, increased uncertainty permits the IRS to exercise more discretion when enforcing tax law which might lead to less uniform enforcement. Third, greater ambiguity can lead to more, and more costly, litigation. Fourth, increased ambiguity may cause taxpayers to report less tax liability. Fifth, risk and ambiguity affect different taxpayers in an undesirably unequal way. Taxpayers who merely want to follow the law may respond

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73 Professor Weisbach describes this argument. See, Weisbach, Ten Truths, supra note 63 at 248 (“[U]ncertainty, it is argued, imposes costs on taxpayers and is a reason to minimize the use of broad antishelter doctrines. The tax law, it is claimed, should provide clear answers to most questions. After all, people need to fill out their tax returns”). However, Professor Weisbach does not seem to espouse this view. Id. at 248 (“[I]t is not clear what the claim is based on other than mere assertion and maybe force of habit, in that many tax laws now provide significant certainty and people are used to this.”); See, also, Rachelle Y. Holmes, Forcing Cooperation: A Strategy for Improving Tax Compliance, 79 CIN. L. REV. 1415, 1441 (2011) (“Ambiguity in either the applicability or content of the law can cause difficulties for [large business entities] and the Service alike in terms of increased time and money spent, even in attempts to merely comply with (as opposed to game) the tax system”).

74 See, e.g., Swire, supra note 54 at 372 (discussing safe harbors in law generally and stating: “An important source of uncertainty is the discretion of lower-level bureaucrats; the safe harbor rule can help senior officials confine that discretion.”)

75 See, e.g., Beale, supra note 11 at footnote 17 (“[Safe harbors] are generally considered helpful because they facilitate tax administration and reduce taxpayer controversies.”); Holmes, supra note 73 at 1437 (“Pre-filing certainty of outcomes ... saves both taxpayers and the IRS the expenditure of significant amounts of time and money in anticipation of, preparing for, and in the process of post-filing battle.”). Also, more generally, Professor Kaplow observes that standards are more costly for courts to apply. Kaplow, Rules Versus Standards, supra note 1 at 562 – 63.

76 See supra note 67 and accompanying text.

77 See, e.g., Sheldon I. Banoff, The Use and Misuse of Anti-Abuse Rules, 48 TAX LAW. 827 (1995) (“The effect of [some anti-abuse rules] ... is to erase the bright line or relocate it for more cautious taxpayers. Those who are overly aggressive may use the vagueness and ambiguity of the rule as an indirect endorsement of their proposals. Thus, conservative practitioners may become more so, and aggressive planners will have a larger client base to solicit.”); Richard J. Kovach, Bright Lines, Facts and Circumstances
to additional risk and ambiguity by structuring their affairs more conservatively and erring on the side of over-reporting income.\textsuperscript{78} Taxpayers who seek to push boundaries and game the system as much as possible will try to take advantage of additional risk and ambiguity by structuring their transactions more aggressively and erring on the side of underreporting income.\textsuperscript{79} Furthermore, we might view this disparate effect of ambiguity and risk as particularly undesirable because it could contribute to the perception that taxpayers who exploit the system are not subject to the same rules that apply to the rest of us. This perception, in turn, could embolden more taxpayers to take aggressive reporting positions and cause more tax advisors to provide aggressive advice in order to effectively compete for client business.\textsuperscript{80}

\textit{Tests, and Complexity in Federal Taxation}, 46 \textsc{Syracuse L. Rev.} 1278, 1303 (1996) (“Risk aversion can produce unnecessarily conservative determinations by practitioners. Yet if the risk of audit is perceived to be relatively slight, some professionals will ignore the ominous implications of a faulty facts and circumstances analysis in favor of taking a turn at the roulette wheel of the audit casino.”); Logue, \textit{Tax Law Uncertainty, supra} note 68 at 374 (“[U]sing such legal uncertainty in this way is a fairly imprecise tool for deterring aggressive tax planning, since some taxpayers will be induced to over-comply and others, the less risk-averse, will be inclined to take a chance and exploit the ambiguity.”); Ososky, \textit{supra} note 55 at 492 (distinguishing ambiguity from risk and stating, “Taxpayers may have divergent reactions to increased ambiguity, whereby taxpayers with a low chance of success on the merits would be more likely to claim tax benefits, whereas taxpayers with a high chance of success on the merits would have the opposite inclination.”). \textit{See, also}, Weisbach, \textit{Ten Truths, supra} note 63 at 249 – 50 (describing this argument but not adopting it, specifically, stating “[T]hose arguing against uncertainty would ...argue that taxpayers vary in their risk aversion, so that uncertainty affects taxpayers differently....This, it might be argued, is unfair--uncertainty in the tax law helps the bad guys and hurts the good guys. It is not clear, however, why this is more unfair than disparate responses to other elements of taxation.”) For a similar observation regarding standards in law generally, \textit{see, e.g.}, Schlag, \textit{supra} note 61 at 385 (“Because standards do not draw a sharp line between permissible and impermissible conduct, some risk-averse people will be chilled from engaging in desirable or permissible activities, and some risk-prefering people will be encouraged to engage in antisocial conduct.”)

\textsuperscript{78} \textit{See supra} note 77.

\textsuperscript{79} \textit{See supra} note 77.

\textsuperscript{80} \textit{See, e.g.}, Beale, \textit{supra} note 11 at 371 (“[T]axpayers ... are more likely to comply if they believe that the tax system is fairly and consistently applied across taxpayers.”); Michael S. Knoll, \textit{Tax Planning, Effective Marginal Tax Rates, and the Structure of the Income Tax}, 54 \textit{Tax L. Rev.} 555, 555 (2001); Leandra Lederman, \textit{The Interplay between Norms and Enforcement in Tax Compliance}, 64 \textit{Ohio St. L. J.} 1453 (2003); Schizer, \textit{supra} note 63 at 1319 (“Since wealthy and well advised taxpayers have an edge in planning, limiting this advantage can lead to a more equitable distribution of tax burdens. The average taxpayer's faith in the system is preserved, promoting voluntary compliance and
3. If Certainty is the Objective, A Rule May Be Superior to a Safe Harbor

As the last section showed, there is no consensus on how certain tax law should be because, while certainty offers some advantages, it also has drawbacks. Because of its potentially undesirable side effects, certainty may not always be our primary goal. However, when it is, we ought to employ a rule rather than a safe harbor, as this part will demonstrate.

When certainty is the prevailing consideration, lawmakers should utilize a rule rather than a safe harbor. Unlike a rule, a safe harbor retains two of the uncertainty-related disadvantages of a standard. First, a desire to constrain the IRS’s enforcement discretion sometimes motivates calls for greater certainty.\(^{81}\) A rule, assuming it is clearly defined, restricts IRS discretion because such a rule leaves the IRS little flexibility when applying it. A safe harbor, by contrast, does not obviate the need for the IRS to make judgment calls in many cases. Some taxpayers will operate outside the bounds of a safe harbor, and the IRS will exercise enforcement discretion in the course of dealing with such taxpayers.

Second, some advocate for greater certainty because uncertainty places the greatest burden upon wary taxpayers who are highly concerned with following the law.\(^{82}\) By contrast, less scrupulous, or at least less risk averse, taxpayers exploit uncertainty by designing more aggressive transactions.\(^{83}\) Adopting a rule, rather than a safe harbor, more effectively addresses this concern, although, compared to a standard, a safe harbor can mitigate this consequence of uncertainty. To demonstrate, consider the following examples: the first illustrates the effects of a rule, the second illustrates the effects of a standard, and the third illustrates the effects of a safe harbor.

Example 1. Two groups of individuals form two partnerships. The first partnership (“Cautious Partnership”) is formed by individuals

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\(^{81}\) See supra note 74 and accompanying text.  
\(^{82}\) See supra note 77 and accompanying text.  
\(^{83}\) See supra note 77 and accompanying text.
who seek to take tax positions that have a high chance of prevailing if audited by the IRS. Assume, for example, that Cautious Partnership will take a tax position only if it views the position as having a 90% or greater chance of being upheld. The second partnership ("Aggressive Partnership") is formed by individuals who prefer to take tax positions that have a lower chance of prevailing if audited. Assume, for example, that Aggressive Partnership will take a tax position even if it views the position as having only a 30% chance of being upheld. Each partnership would like to allow partners to sell interests as frequently as possible without becoming a publicly-traded partnership for tax purposes. Furthermore, assume that, contrary to current law, the rule determining whether or not a partnership is publicly traded states: If not more than two percent of interests in a partnerships are traded per year, the partnership is not publicly traded, and, if more than two percent of interests are traded, the partnership is publicly traded.

Given the facts of Example 1, Cautious Partnership and Aggressive Partnership would each permit the sale of two percent of their interests but no more. Each partnership knows beyond a doubt that it can allow that much trading and maintain its non-publicly traded partnership status. In other words, each partnership knows that, if it allows that much trading and takes the position that it is not publicly traded, that position has a 100% chance of being upheld. Because this 100% probability satisfies the threshold required by Cautious Partnership (90%) and the threshold required by Aggressive Partnership (30%), each partnership can comfortably decide to allow the sale of two percent of its interests. Furthermore, each partnership also knows beyond a doubt that allowing partners to sell 2.01% of its interests would cause it to lose non-publicly traded status. In other words, each partnership knows that if it permitted 2.01% trading and took the position that it was not publicly traded that position would have a 0% chance of success on audit. Because 0% is lower than the probability required by each partnership, neither partnership will permit its partners to sell more than two percent of the interests in the partnership. Example 1 is illustrated in the chart below.
Now consider the facts of the following example which illustrates the effects of a standard.

**Example 2.** The facts are the same as Example 1 but with an important change in the law. There is no longer a rule providing that a partnership is not publicly traded if, and only if, not more than two percent of its interests are traded in a year. Instead, taxpayers are informed that a partnership will be publicly traded if the partnership is listed on an established securities exchange or the amount of trading of the partnership’s interests is comparable to the amount of trading one would expect to find in a partnership listed on such an exchange. Assume Aggressive Partnership believes 15% is the maximum percentage of interests partners can trade for the partners to still have a 30% chance of being treated as non-publicly traded. Cautious Partnership believes 1.5% is the maximum percentage of interests partners can trade while maintaining a 90% chance that the partnership will be treated as non-publicly traded.\(^\text{84}\)

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\(^{84}\) The partnerships might differ not only in their required level of confidence but also in the probabilities each subjectively assigns to a given tax position being upheld. For instance, although Aggressive Partnership believes it has a 30% chance of being treated as non-publicly traded with 15% trading, Cautious Partnership might assign only a 20% probability to the same occurrence. For discussion of this subjective element of probabilities in tax law, see, e.g., Lawsky, *Probably?*, supra note 55. This difference
Given the facts of Example 2, one would expect that Aggressive Partnership will allow more trading than Cautious Partnership. In particular, Aggressive Partnership will permit partners to trade 15% of interests in the partnership while Cautious Partnership will allow partners to trade only 1.5% of their partnership interests. Example 2 is illustrated in the chart below.

As Example 2 demonstrates, when faced with uncertainty, taxpayers behave very differently depending on their tolerance for risk. By contrast, as shown in Example 1, when taxpayers confront a clear rule, their risk tolerance does not affect their behavior. Therefore, if lawmakers view as undesirable the disparate effects of risk, adopting a rule fully addresses their concern. However, as Example 3 illustrates, although a safe harbor may fare better than a standard, compared to a rule, a safe harbor may be more prone to causing taxpayers to design transactions differently depending on their tolerance for risk and ambiguity.85

Example 3. The facts are the same as Examples 1 and 2 but with an important change in the law. In particular, a safe harbor provides between Aggressive Partnership and Cautious Partnership increases as ambiguity rises. In other words, as ambiguity increases, probability judgments will vary more from partnership to partnership because the probability of a given outcome will be less clear.

85 This is less likely to be true in the case of very permissive safe harbors, given that such safe harbors function as de facto rules. See infra Part II.D.
that a partnership is not publicly traded if not more than two percent of interests in the partnership are traded in a year. However, unlike in Example 1, more than 2% trading does not automatically cause a partnership to become publicly traded. Instead, such a partnership is publicly traded if and only if the partnership is listed on an established securities exchange or the extent of trading of the partnership’s interests is comparable to what one would expect to find in a partnership listed on such an exchange.

In Example 3, Aggressive Partnership might still allow more trading than Cautious Partnership either because Aggressive Partnership is more willing than Cautious Partnership to operate outside the safe harbor or because Aggressive Partnership operates further outside the safe harbor than Cautious Partnership.\textsuperscript{86} By allowing more than 2% trading, a partnership faces increased risk (because its chances of being treated as non-publicly traded are less than 100%) and increased ambiguity (because its chances of being treated as non-publicly traded are unknown). If Aggressive Partnership is willing to face the increased ambiguity associated with operating outside the safe harbor and if Aggressive Partnership still judges the chances of being non-publicly traded when allowing 15% trading to be 30%, Aggressive Partnership will allow 15% trading.\textsuperscript{87} Cautious Partnership, by contrast, is more likely to operate within the safe harbor and face lower risk and lower ambiguity. Example 3 is illustrated in the chart below.

\textsuperscript{86} For a related point in the context of safe harbors in law generally, see, Swire, supra note 54 at 375 (“Some entities will judge operation under a vague standard as too risky, and will have a strong preference (i.e., will be willing to pay a premium) for complying with the objective criteria of a rule. A safe harbor will satisfy the preferences of these entities that are averse to regulatory risk or are relatively less able to estimate their likelihood of being sanctioned for violating the standard. The standard will remain available for other entities that do not wish to meet the safe harbor or otherwise have lower perceived costs of complying with the standard.”)

\textsuperscript{87} For an example of aggressive taxpayers operating outside a safe harbor, one can look to management fee waivers undertaken by private equity fund managers which, depending on how they are structured, may not qualify for the safe harbor in Rev. Proc. 93-27. For further discussion, see Gregg D. Polsky, Private Equity Management Fee Conversions, 122 TAX NOTES 743 (2009).
Thus, if lawmakers strongly dislike provisions that prompt aggressive taxpayers to behave differently than cautious ones, they should opt for clear rules rather than safe harbors or standards. Clear rules eliminate entirely this disparate reaction of taxpayers, while safe harbors retain it, at least to some extent. However, compared to standards, safe harbors can, in some cases, lessen the plight of cautious taxpayers. Even the most wary taxpayer will comfortably design a transaction that lies just inside the limits of a safe harbor, and this transaction could be significantly bolder than the one in which the wary taxpayer engages when he or she confronts a standard that is not supplemented by a safe harbor.

B. Safe Harbors Soften The Consequences of Arbitrary Distinctions

As discussed in the last section, when lawmakers deem certainty to be paramount, they should employ a rule. However, as this section will show, a safe harbor can ameliorate the arbitrary results of some rules. This part will proceed by, first, discussing why arbitrary distinctions are problematic. Second, this part will describe how safe harbors can lessen the negative consequences of arbitrary distinctions. Third, this part will discuss limits on the ability of safe harbors to eradicate arbitrariness.\(^\text{88}\)

\(^{88}\) For discussion of the arbitrary nature of rules, generally, see, e.g., Sunstein, supra note 61 at 978 (“The third challenge is that the generality of rules, and their blindness to particulars, is a political vice, because a just system would allow equity through
1. Why Are Arbitrary Distinctions Problematic?

Arbitrariness arises when significant tax differences turn upon minor non-tax distinctions. For instance, arbitrariness would arise if one partnership, in which 2% of interests were transferred during a year, were treated as non-publicly traded while another, otherwise identical, partnership were treated as publicly-traded merely because 2.01% of interests in that partnership were transferred during a year. Arbitrariness is problematic because it likely undermines tax law’s primary purposes. A 2% trading line may be drawn for reasons of administrative convenience but not because lawmakers, in fact, seek to achieve their policy goals by taxing partnerships differently based on a distinction as meaningless as whether or not an additional 0.01% interest in the partnership changes hands in a given year.

2. How Do Safe Harbors Soften The Consequences of Arbitrary Distinctions?

Under rules, significant tax consequences may depend on arbitrary distinctions. For instance, if the safe harbors currently used for determining publicly-traded partnership status were replaced with rules, the law could provide that a partnership is not publicly traded if no more than 2% of interests in the partnership are transferred in a given year, while a partnership is publicly traded if more than 2% of interests in the partnership are transferred in a year. Such a rule would cause the adaptation to the particulars of individual cases.”) Id. at 992 (“If strictly followed, the rule will often produce arbitrariness and errors in particular cases.”)

This depends in part on how the rule is designed because some rules may be more arbitrary than others. See infra Part II.B.3. For further discussion of rules’ arbitrariness, see, e.g., John A. Miller, Indeterminacy, Complexity, and Fairness: Justifying Rule Simplification in the Law of Taxation, 68 WASH. L. REV. 1, 43 (1993) (“[The] essential feature [of mathematical rules] is the failure to distinguish between individual circumstances in their application in a way that is more pronounced than other rules. In short, the mathematical rule is overtly arbitrary. This overt arbitrariness accounts for its relative determinacy....Arbitrariness, to the extent it achieves determinacy, may be seen to do so at the sacrifice of legitimacy.”) For a similar observation regarding rules generally, see, e.g., Colin S. Diver, The Optimal Precision of Administrative Rules, 93 YALE L.J. 65, 67 (1983) (“A rule that makes eligibility for disability insurance turn on one's birth date, the argument runs, fails adequately to discriminate between those who are capable and those who are incapable of supporting themselves.”)
situation described above in which one partnership receives different tax treatment than another partnership merely because of a very small difference in the percentage of interests transferred.

The consequences of straying beyond the 2% trading line are less harsh if, as is the case under current law, staying at or below a 2% trading threshold represents merely the outer bounds of a safe harbor rather than a necessary requirement for obtaining non-publicly-traded status. Given that 2% trading is merely a requirement to qualify for a safe harbor, two partnerships can receive the same tax treatment when they are identical in all respects but for the fact that 2% of interests are traded in one partnership while 2.01% of interests are traded in the other partnership.

3. Why Is The Value of Safe Harbors Limited?

Although safe harbors mitigate arbitrariness, their value is limited for two reasons. First, a differently designed rule need not be as arbitrary. Thus, rather than rely on safe harbors to ameliorate arbitrariness, lawmakers could, instead, focus their efforts on designing rules that drew distinctions between more meaningfully different transactions. Along similar lines, the consequences of arbitrary distinctions could be lessened if discontinuous tax rules were replaced with gradual rules. For instance, rather than taxing publicly-traded partnerships differently than non-publicly-traded partnerships, the tax system could provide for a gradual increase in tax liability as the extent of trading increased.

Second, even with safe harbors, inevitably courts must distinguish among different taxpayers. Taking the publicly-traded rules as an example, some partnerships that do not qualify for safe harbors will be granted non-publicly traded status and some will not. When sorting partnerships between these categories, courts must draw lines, and, inevitably,
somewhat similar partnerships will be treated differently. Nevertheless, because courts can evaluate multiple factors in a flexible way when making distinctions among taxpayers, they may be able to sort taxpayers into categories less arbitrarily than a rule would do.

C. Safe Harbors Are More Forgiving Than Rules So They Are Less Likely To Trap Unwary Taxpayers

As discussed above, one of safe harbors’ virtues is that they soften the consequences of arbitrary distinctions. In addition, when lawmakers prioritize fairness, they will find that safe harbors accomplish their goals more effectively than rules. In particular, safe harbors promote fairness because they are more forgiving of taxpayers who fail to meet their requirements. Therefore, unsophisticated taxpayers may be less likely to commit costly errors when faced with safe harbors.

In the case of a rule, some taxpayers will find themselves on the wrong side of the line because they failed to receive advice, or received inadequate advice, before acting. As a result, those taxpayers will forgo the opportunity to obtain more favorable tax consequences. Thus, rules can trap unwary taxpayers. This aspect of rules is particularly troubling.

See, also, David A. Weisbach, Line Drawing, Doctrine, and Efficiency in the Tax Law, 84 CORNELL L. REV. 1627, 1646 - 47 (1999) [hereinafter, Weisbach, Line Drawing] (concluding that, inevitably, similar taxpayers will be treated differently). However, this difference should not be overstated given that a rule could also employ multiple factors.

In a similar vein, Professor Kovach argues that unsophisticated advisors may fare better under standards than rules, stating, “[i]f many important tax determinations are based on facts and circumstances tests, practitioners who are not very familiar with a particular taxation subject might experience less anxiety about their lack of knowledge, since vague standards allow for at least arguable compliance over a wide range of putatively misguided transactions. Error under bright line rules is more clearly established and displayed.” Kovach, supra note 77 at 1315 – 16. For a similar observation regarding rules and standards in the property law context, see, e.g., Rose, supra note 61 at 601 (discussing how crystalline rules in property law tend to disadvantage “fools” and favor “sharp dealers” and stating that fuzzier standards “will also reassure those of us who fear we may be made fools; we can go about our business and take part in the world of trade without cowering at home because we think we need to hire a lawyer and an accountant every time we leave the car at the commercial parking lot.”)

For discussion of the general idea that tax planning opportunities disadvantage unsophisticated taxpayers, see, e.g., Heather M. Field, Choosing Tax: Explicit Elections as an Element of Design in the Federal Income Tax System, 47 HARV. J. ON LEGIS. 21, 23-24
because unwary, unsophisticated taxpayers may tend to be less wealthy than taxpayers who are sufficiently sophisticated to seek tax advice before acting. As a result, rules can disproportionately benefit wealthy taxpayers while disadvantaging less wealthy taxpayers. Therefore, the bias against unsophisticated taxpayers is problematic because it contributes to increasing wealth inequality and interferes with the progressivity of the tax system. Furthermore, this bias can perpetuate the perception that the tax system is unfair which can, in turn, undermine voluntary tax compliance.96

One might argue that safe harbors, or even standards, are no better. Even when safe harbors or standards govern tax consequences, an unsophisticated taxpayer may fail to seek advice prior to acting and, therefore, may arrange his or her activities in a way that is different than what a tax lawyer would suggest. Furthermore, to the extent that rules are easier to apply than standards,97 standards might disadvantage unsophisticated taxpayers even more severely than rules.

However, although rules may be easier to apply than standards, ease of application assists only taxpayers who attempt to apply the rules.98 While sophisticated taxpayers will often attempt to apply tax law before acting, either directly or by seeking tax advice, unsophisticated taxpayers may be unaware of any need to consult with a tax advisor prior to acting. Therefore, unsophisticated taxpayers may fail systematically to reap the benefits of easy to apply rules. Luckily for such taxpayers, if the rules represent merely the outer bounds of a safe harbor rather than exclusive requirements for obtaining favorable tax treatment, all will not be lost.

(2010); Schizer, supra note 63 at 1319.

96 See supra note 80.

97 See, e.g., Kaplow, Rules Versus Standards, supra note 1 at 577 ("[R]ules' benefits arise from two sources: Individuals may spend less in learning the content of the law, and individuals may become better informed about rules than standards and thus better conform their behavior to the law.")

98 For a related point, see, e.g., Kaplow, Rules Versus Standards, supra note 1 at 564 ("[T]he advantage of rules at the stage involving individuals' behavior depends on whether individuals choose to acquire legal advice before they act.") Professor Kaplow argues that individuals may be less likely to acquire information about standards ahead of time because standards are more difficult to apply. Id. For that reason, it may be true that a taxpayer who is sophisticated enough to seek advice will more likely obtain information about rules than standards. However, unsophisticated taxpayers may be less likely to seek any legal advice ahead of time because they may be unaware of the benefits of tax planning.
Taxpayers operating outside the bounds of a safe harbor have a chance of obtaining favorable tax outcomes under the standard applicable to them.\(^9^9\)

To illustrate, assume an individual who is neither a U.S. citizen nor a lawful permanent U.S. resident were present in the United States for 180 days in the current year and 9 days in the previous year. This individual would have been present for too many days to qualify for a safe harbor assuring that he or she was not a U.S. person for tax purposes this year.\(^1^0^0\) However, he or she would retain the opportunity to escape treatment as a U.S. person if he or she had a tax home in a non-U.S. country and had a closer connection to that other country than to the United States, taking into account all relevant facts and circumstances.\(^1^0^1\)

Furthermore, although a rule may be easier to apply than a standard when a person seeks information about the rule, a standard may be, in some sense, “easier” than a rule for unsophisticated taxpayers. A standard may be “easier” for unsophisticated taxpayers because it may be more likely than a rule to coincide with a taxpayer’s uninformed expectations.\(^1^0^2\) This observation follows from the arbitrariness of some clear rules.\(^1^0^3\)

To illustrate, we can refer again to the example of the provisions governing whether or not an individual will be treated as a U.S. person for tax purposes. There is no reason why an uninformed person would have any intuitive estimate of the exact number of days he or she can remain in the United States without falling outside of the bounds of a safe harbor because the number of days is inherently arbitrary. However, a person may have some intuitive sense that closer connections with the United States would be more likely to trigger U.S. tax consequences. Therefore,

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\(^9^9\) This is true unless the safe harbor is very permissive. As defined and discussed below, a safe harbor is very permissive when its outer bounds lie close to the outer bounds of the underlying standard so that a taxpayer who operates outside the safe harbor is unlikely to receive the same tax treatment as taxpayers who operate within it. See infra Part II.D.

\(^1^0^0\) See supra Part I.B.1.

\(^1^0^1\) See supra Part I.B.3.

\(^1^0^2\) See, also, Kaplow, Rules Versus Standards, supra note 1 at 562 (describing how, when individuals decide how to act, they either seek legal advice or “act based on their best guess of the law”).

\(^1^0^3\) As discussed above, some rules may be more arbitrary than others. See supra Part II.B.3.
someone who acts without obtaining advice may be more likely to act consistently with standards than with rules. Because safe harbors, unlike rules, preserve background standards that apply to taxpayers outside the safe harbor, unsophisticated taxpayers will fare better under safe harbors than under rules.

Moreover, one of the potential advantages of a rule is that it can decrease taxpayers’ decision costs. Taxpayers who attempt to understand tax law prior to acting can learn the parameters of a rule more readily than they can discover the boundaries of a standard. Safe harbors retain this benefit of rules. Taxpayers who do endeavor to learn tax law prior to acting can inform themselves about the tax consequences of their transactions more easily if lawmakers provide them with a safe harbor instead of leaving them to cope with a mere standard.

In summary, safe harbors are better equipped than rules for assisting unsophisticated taxpayers, in part, because they are more lenient and, in part, because they retain underlying standards that may be more likely than arbitrary rules to coincide with a taxpayer’s uninformed expectations. At the same time, by reducing decision costs, safe harbors assist taxpayers who do seek information about tax law prior to acting.

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104 This benefit of standards is limited by the fact that, eventually, courts have to apply standards, and, when applied, standards can lead to arbitrary results. See supra Part II.B.3.

105 Thus, although distributional concerns may not provide sufficient guidance regarding where tax law should draw a given line, these concerns may suggest how a line should be drawn in that the line should be drawn in a more flexible way. For discussion of the observation that distributional concerns do not provide guidance regarding where lines should be drawn, see, Weisbach, Line Drawing, supra note 92 at 1647 – 48. Combining a safe harbor with a rule mandating generally unfavorable tax treatment undermines, to a degree, this potential advantage of a safe harbor. The taxpayer in the previous example who has no intuitive sense of where arbitrary lines are drawn might remain in the United States for 183 days this year. In such a case, the taxpayer would lose the opportunity to show that he or she had a closer connection with a non-U.S. country and would be treated automatically as a U.S. person for tax purposes. See supra note 50 and accompanying text.

106 See, e.g., Kaplow, Rules Versus Standards, supra note 1.

107 This is true unless the safe harbor is a very restrictive safe harbor that functions, effectively, as a standard. As defined and discussed below, a safe harbor is very restrictive when its outer bounds lie far from the outer bounds of an underlying standard. Such a safe harbor provides taxpayers with little additional information compared to what they would surmise if they faced a mere standard. See infra Part II.D.
D. Compared to Rules or Standards, Safe Harbors May Be Less Likely To Distort Taxpayers’ Decision Making in Some Cases

As discussed in the previous sections, lawmakers striving for certainty should employ rules rather than safe harbors, while lawmakers aiming for fairness should utilize safe harbors rather than rules. This section analyzes the question of which type of provision is least likely to distort taxpayers’ decision making. As this part will show, one possible virtue of safe harbors, compared to either rules or standards, is that they may less severely distort taxpayers’ decision making in some cases. \(^{108}\) However, ultimately, whether or not a safe harbor has this effect depends on where the boundary of the safe harbor lies in relation to taxpayers’ non-tax preferences and on how “permissive” or “restrictive” the safe harbor is, as defined and discussed in detail below.

Tax law, like many areas of law, involves line drawing.\(^ {109}\) Often, tax law affords different tax treatment to transactions on opposite ends of a continuum. In such cases, lawmakers must engage in line drawing to determine how to treat transactions that fall between the ends of the continuum. Once the line is drawn, transactions on one side will be treated one way while transactions on the other side will be treated in a different way. For example, financial instruments that are classified as debt for tax purposes receive quite different treatment than instruments that are classified as equity for tax purposes.\(^ {110}\) In extreme cases, it will be easy to classify an instrument as either debt or equity. For instance, an

\(^{108}\) This is a virtue when lawmakers are not trying to distort taxpayers’ decisions. When lawmakers are trying to distort taxpayers’ decisions, this analysis remains relevant because it sheds light on the type of provision that will most effectively accomplish that goal as well.


\(^{110}\) For instance, if a corporation issues a financial instrument that is treated as debt for tax purposes, the corporation will be entitled to deduct interest expense, but, if the instrument is treated as equity for tax purposes, the corporation will not be entitled to a deduction for payments made on the instrument. Boris I. Bittker & James S. Eustice, Federal Taxation of Corporations and Shareholders ¶ 4.01[2](2d ed. 1989)(“Section 163(a) allows the payor corporation to deduct ‘all interest paid or accrued within the taxable year on indebtedness,’ but no comparable deduction is allowed for distributions to the corporation’s shareholders.”)
instrument issued by a taxpayer to an unrelated party that provides for fixed payments and a short term to maturity is almost certainly debt. At the other extreme, typical, voting common stock is almost certainly equity. In between these poles lie a variety of financial instruments with some equity-like and some debt-like features. Current law employs a standard to draw the line between debt and equity and classify financial instruments along the continuum. In particular, an instrument will be treated as debt rather than equity if the parties intend the holder of the instrument to have a definite right to be repaid a fixed amount at a certain time, regardless of the income of the obligor. To determine the parties’ intent, courts will examine all relevant facts and circumstances including the terms of the instrument.

Many of the safe harbors discussed in this Article also involve line drawing. For example, consider the publicly-traded partnership rules. At one end of the spectrum, some partnerships are clearly publicly traded. For instance, a partnership whose interests are listed on the New York Stock Exchange inhabits this end of the spectrum. At the other end of the spectrum, a mom and pop partnership with few owners and stable ownership is clearly not publicly traded. In between these extremes exist many partnerships whose interests are traded with varying degrees of frequency.

As Professor Weisbach and other scholars have observed, the location of a given line can have important efficiency consequences. This is the case because taxpayers who want to achieve a given tax outcome may arrange their transactions differently depending on where a line is drawn. If the line’s location causes a taxpayer to engage in a transaction that differs from the transaction in which the taxpayer would have engaged, but for the resulting tax consequences, the transaction undertaken may be inefficient from a societal point of view.


113 A numerical example illustrates this effect of line drawing. Assume, by engaging in one transaction (Transaction A), a taxpayer would earn, over one year, a 15% pre-tax return, but a 10% after-tax return. Transaction A is on one side of a given line and, as a result, receives less favorable tax treatment and is taxed at an effective tax rate of
Professor Weisbach argues that, if line drawing is inevitable, in order to mitigate distortions lines generally should be drawn so that similar transactions are treated similarly.\textsuperscript{114} A line drawn between transactions that are very different from a non-tax perspective is less likely to distort taxpayers’ decision making than a line drawn between similar transactions, all else being equal. This observation is plausible because taxpayers are less inclined to make large non-tax changes than small non-tax changes in order to move to the other side of a given line, all else being equal. Thus, a line separating transactions that are very different from a non-tax perspective is less likely to induce taxpayers to change their transactions for tax reasons.

Rather than affecting where a line is drawn, using a safe harbor instead of a rule or a standard affects how a line is drawn, in that it affects how crisp or blurry the line is. How a line is drawn may, too, have efficiency consequences. To demonstrate that the manner in which a line is drawn has efficiency consequences, this section will proceed by, first, comparing the distortions caused by safe harbors to the distortions caused by standards and, second, comparing the distortions caused by safe harbors to the distortions caused by rules.

1. Distortions Caused by Safe Harbors Compared to Distortions Caused by Standards

\textsuperscript{114} Weisbach, \textit{Line Drawing}, supra note 92; Weisbach, \textit{Efficiency Analysis}, supra note 109.
Compared to a standard, a safe harbor draws lines more crisply, so that taxpayers assess their tax consequences more clearly. As a result, a safe harbor may mitigate distortions and their resulting inefficiency for taxpayers who easily qualify for the safe harbor. These taxpayers can decide upon the parameters of their transactions without fearing less favorable tax treatment, provided that they remain within the safe harbor. By contrast, compared to a standard, a safe harbor may exacerbate distortions for taxpayers whose non-tax preferences lie close to but outside of the bounds of the safe harbor. These taxpayers may be more inclined to rearrange their affairs for tax purposes when confronted by a safe harbor rather than a standard.

The publicly-traded partnership rules can be used to demonstrate these observations. Under current law, a partnership can qualify for safe harbor treatment that ensures non-publicly traded status as long as interests in the partnership are not listed on an exchange and no more than two percent of the interests in the partnership are traded in any given year. To illustrate the safe harbor’s effects on distortions, one can contrast current law with a hypothetical standard providing that a partnership is publicly traded if interests in the partnership are traded to an extent that is consistent with public trading.

Consider the following example in which the safe harbor mitigates distortions compared to a standard.

**Example 4.** Assume interests in a partnership are not listed on an exchange. Assume that absent tax considerations the partnership would allow partners to sell 1.5% of the interests in the partnership per year, which would be ideal from a non-tax perspective.

With a 2% trading safe harbor, this partnership can allow 1.5% trading without worrying that the partnership might become publicly traded. Thus, if the partnership has non-tax reasons for allowing 1.5% trading, tax consequences will not discourage the partnership from doing so, and, as a result, the goal of fostering efficiency will be furthered. The analysis is importantly different under the hypothetical standard providing that a partnership is publicly traded if interests in the partnership are traded to an extent that is consistent with public trading.

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115 For a related point regarding rules, see Weisbach, Formalism supra note 68 at 873.
116 See supra Part I.A.1.
traded to an extent that is consistent with public trading. Under this standard, each additional partnership interest sold, even in a partnership in which fewer than 2% of interests change hands, brings additional risk, and this additional risk might induce a partnership to disallow trading even when, tax consequences aside, additional liquidity would be beneficial. Thus, a standard can distort a partnership’s decisions by causing it to disallow trading that would have been permitted but for the tax consequences. Example 4 is illustrated in the following chart.

\[\text{Percentage of Interests Traded in a Year}\]

\(0\%\) \(2\%\)

\(0\%\) \(2\%\)

\(\text{Result: Partnership with non-tax preference for } 1.5\% \text{ trading allows } 1.5\% \text{ trading.}\)

\(\text{Result: Partnership with non-tax preference for } 1.5\% \text{ trading may allow } 1.5\% \text{ trading but may allow less than } 1.5\% \text{ trading.}\)

**Example 4: When Safe Harbors Can Cause Less Distortion Than Standards**

Whether a safe harbor will mitigate distortions in the manner discussed in Example 4 depends, in part, on how “permissive” or “restrictive” the safe harbor is. A safe harbor is more permissive when its outer bounds approach the likely outer bounds of the underlying standard.

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\[^{117}\text{For a similar observation regarding the effects of gradual rules, see Weisbach, Formalism, supra note 68 at 873 – 74.}\]
A safe harbor is more restrictive when its outer bounds lie well within the likely outer bounds of the underlying standard. Safe harbors that are very restrictive do little to mitigate distortions, compared to a standard, because even taxpayers faced with only a standard would surmise that they could operate up to the outermost bounds of a restrictive safe harbor and receive favorable tax treatment.

While Example 4 showed that safe harbors can mitigate distortions caused by standards, the following example will show that, under different facts, a safe harbor can exacerbate distortions caused by standards.

**Example 5.** Assume interests in a partnership are not listed on an exchange. Assume, absent tax considerations, the partnership would allow partners to sell 2.1% of their interests in the partnership per year because doing so would be ideal from a non-tax perspective.

Under these facts, the partnership may be more likely to allow 2.1% trading when faced with a standard than when faced with a 2% trading safe harbor. The partnership faces a significantly greater increase in risk and ambiguity by allowing 2.1% trading (rather than 2% trading) under the safe harbor than it would under a standard. Example 5 is illustrated in the following chart.
The likelihood that a safe harbor will exacerbate distortions as shown in Example 5 depends, in part, on how permissive or restrictive the safe harbor is. If the safe harbor is restrictive (meaning its outer bounds lie well within the likely outer bounds of the underlying standard), a taxpayer would be more inclined to operate outside the safe harbor than if the safe harbor is permissive (meaning its outer bounds approach the likely outer bounds of the underlying standard), all else equal. Thus, as the safe harbor becomes increasingly permissive, the distortions that occur when taxpayers’ non-tax preferences fall outside the safe harbor are increasingly likely to occur.

Another way to conceptualize this observation is to view very permissive safe harbors as *de facto* rules and very restrictive safe harbors as *de facto* standards. A very permissive safe harbor functions as a *de facto* rule because a taxpayer who operates outside such a safe harbor will
almost certainly receive tax treatment that differs from the treatment of taxpayers within the safe harbor, which is the same result that follows the failure to comply with a rule. A very restrictive safe harbor operates as a de facto standard because it provides the taxpayer with little more information than what the taxpayer would have if he or she were confronted with a standard. Imagine that a safe harbor applied to partnerships in which no interests were traded during a year. Because taxpayers would assume, even without the safe harbor, that a partnership in which no interests were traded was not publicly traded, this safe harbor would add no useful information to the background standard and, thus, would constitute a de facto standard. Furthermore, because very restrictive safe harbors are equivalent to de facto standards, restrictive safe harbors are less likely than permissive safe harbors to either mitigate or exacerbate distortions resulting from standards.

2. Distortions Caused by Safe Harbors Compared to Distortions Caused by Rules

The previous section juxtaposed the distortions caused by safe harbors against the distortions caused by standards. This section will compare a safe harbor’s distortions with the distortions of a rule. Compared to a rule, a safe harbor functions more flexibly, because taxpayers who do not comply with a safe harbor might nevertheless receive favorable tax treatment. Thus, safe harbors may mitigate distortions more effectively than rules for taxpayers with non-tax reasons for operating close to but outside the bounds of the safe harbor.\(^\text{118}\) By contrast, compared to a rule, a safe harbor may exacerbate distortions for taxpayers with non-tax reasons for operating further outside the bounds of

\(^{118}\) See, also, Levmore, supra note 11 at 920 (“We should note that this comparison may be the source of safe harbors’ value--safe harbors minimize the problem of discontinuities.”); Swire, supra note 54 at 373 (discussing safe harbors in law generally and stating, “Compared to a rule-based regime, the safe harbor would reduce the costs of overinclusion and underinclusion. If a rule is too strict, then socially desirable behavior will be prohibited.”) For a related point about taxpayers’ responses to standards, see Weisbach, Formalism, supra note 68 at 873 (“Standards, ex post, have the same discontinuity. A marginal change to a transaction can change the application of the law. The courts or administrators who give content to standards have no greater ability to avoid the line drawing problem than Congress or the regulators who give content to rules. But ex ante, the taxpayer only knows probabilities. A small change in facts will only change the probability a little, creating a continuous change in the law from an ex ante perspective.”)
the safe harbor (but not so far that they have no hope of obtaining favorable tax treatment by moving a little closer).

To demonstrate these observations, consider again the publicly-traded partnership rules. Under current law, a partnership can qualify for safe harbor treatment that ensures non-publicly traded status as long as interests in the partnership are not listed on an exchange and no more than 2% of the interests in the partnership are traded in a given year.\(^\text{119}\) Contrast current law with a hypothetical rule providing that a partnership will be publicly traded if more than two percent of the interests in the partnership are traded in a year and will not be publicly traded if two percent or fewer of the partnership’s interests are traded in a year.

Consider the following example in which the safe harbor mitigates distortions compared to a rule.

**Example 6.** Assume interests in a partnership are not listed on an exchange. Assume, absent tax considerations, the partnership would allow partners to trade 2.1% of its interests because doing so would be ideal from a non-tax perspective.

This partnership will be more inclined to allow 2.1% trading under current law (in which the 2% trading line is merely the outer bounds of a safe harbor) than under a rule (providing that allowing more than 2% trading automatically triggers publicly-traded status). In general, this difference between rules and safe harbors is, however, only a matter of degree. Even in the case of a safe harbor, additional certainty regarding tax consequences may be sufficient to induce taxpayers to change their behavior to fit within the safe harbor. Example 6 is illustrated in the following chart.

\(^{119}\) See *supra* Part I.A.1.
A safe harbor is more likely to mitigate the distortion shown in Example 6 if the safe harbor is restrictive (meaning very far from the outer bounds of what is likely allowed under the standard), assuming that the rule coincides with the outer bounds of the safe harbor. If, by contrast, the safe harbor is very permissive, a taxpayer who operates outside the bounds of the safe harbor faces a high risk of unfavorable tax treatment, and, thus, the safe harbor will be less likely to mitigate distortions compared to a rule that coincides with the outer bounds of the safe harbor. As discussed above, very permissive safe harbors act as de facto rules.\(^\text{120}\) Thus, they are unlikely to provide many efficiency advantages compared to rules.

While Example 6 showed that a safe harbor can mitigate distortions caused by a rule, the following example will demonstrate that, under different facts, a safe harbor can exacerbate distortions caused by a rule.

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\(^{120}\) See *supra* Part II.D.1.
Example 7. Assume interests in a partnership are not listed on an exchange. Assume, absent tax considerations, the partnership would allow 4% of the interests in the partnership to change hands in a year because doing so would be ideal from a non-tax perspective. The partnership would be willing to allow as little as 2.5% trading in order to obtain more favorable tax consequences, but, under no circumstances, would the partnership allow less than 2.5% trading.

Under these facts, the partnership is more likely to allow 4% trading under a 2% trading rule than under a 2% trading safe harbor. Because the partnership, for non-tax reasons, cannot restrict trading to 2%, the partnership cannot receive favorable tax treatment under a rule. Therefore, faced with a rule, the partnership will allow 4% trading because doing so leads to the same tax treatment as restricting trading to 2.5%. When faced with a safe harbor, on the other hand, the partnership may allow less than 4% trading because each disallowed trade increases the chances that the partnership will be treated as non-publicly-traded under the standard that applies to partnerships operating outside the safe harbor. Example 7 is illustrated in the following chart.

**Example 7: When Safe Harbors Can Cause More Distortions Than Rules**
A safe harbor is more likely to exacerbate the distortion shown in Example 7 if the safe harbor is restrictive (meaning very far from the outer bounds of what is likely allowed under the standard), assuming in all cases that the boundary of the safe harbor is in the same location as the rule. If, by contrast, the safe harbor is very permissive, the safe harbor is a *de facto* rule. As a result, the partnership would assume that it would not receive favorable tax treatment unless the extent of trading dropped to 2%, which is precluded by non-tax reasons. Thus, under either a rule or a very permissive safe harbor the distortion shown in Example 7 is not likely to occur.

3. Distortions in Summary

In summary, it is not possible to form a universal conclusion regarding the effects of safe harbors on distortions. However, the following observations emerge from the foregoing analysis.

First, in some situations, a safe harbor will be less likely than a rule but more likely than a standard to cause distortions, all else equal. This tends to occur when taxpayers’ non-tax preferences are located beyond but close to the bounds of the safe harbor as illustrated by Examples 5 and 6 above.

Second, in some cases, a safe harbor will be less likely than a standard but no less and no more likely than a rule to cause distortions, all else equal. Such a case will arise when taxpayers’ non-tax preferences are within the bounds of the safe harbor as shown in Example 4 above.

Third, in still other cases, a safe harbor will be more likely than a rule but no less and no more likely than a standard to cause distortions, all else equal. These effects occur when taxpayers’ non-tax preferences lie fairly far outside the bounds of the safe harbor (but not so far that taxpayers have no hope of obtaining more favorable tax treatment by moving a little closer) as shown in Example 7.

Fourth, extremely permissive safe harbors operate as *de facto* rules because taxpayers can receive specified tax treatment only by complying with such safe harbors. Because an extremely permissive safe harbor is a *de facto* rule, it distorts taxpayers’ decisions to the same degree as a rule drawn in the same location and may distort decisions more or less than a standard depending upon taxpayers’ non-tax preferences.
Fifth, extremely restrictive safe harbors function as *de facto* standards because they essentially provide taxpayers with no more information than taxpayers could surmise if faced with a standard. Because an extremely restrictive safe harbor is a *de facto* standard, it distorts taxpayers’ decisions to the same degree as a standard and may distort decisions more or less than a rule drawn in the same location depending on taxpayers’ non-tax preferences.

Finally, the foregoing analysis was premised on the assumption that the outer limits of a safe harbor are clearly defined. When that assumption does not hold true—in other words, when the requirements of a safe harbor are, themselves, standard-like—the safe harbor may function in a manner similar to a standard.

III. OTHER RULE-STANDARD HYBRIDS IN TAX LAW

Safe harbors are not the only rule-standard hybrids in tax law. Other hybrids include presumptions that may or may not be rebuttable. Four types of presumptions are described below.

A. Irrebuttable Presumptions that Lead to Generally Favorable Tax Consequences

An irrebuttable presumption that leads to generally favorable tax consequences is simply another way of describing a safe harbor. For instance, the safe harbors under which a partnership is assured of receiving non-publicly traded treatment could be described as creating an irrebuttable presumption that a partnership is not publicly traded.

B. Rebuttable Presumptions that Lead to Generally Favorable Tax Consequences

A rebuttable presumption that leads to generally favorable tax consequences could be conceptualized as a semi-safe harbor. A

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121 For discussion of variations on legal provisions more generally, see, e.g., Sunstein, *supra* note 61 at 960 – 68 (discussing rules, rules with excuses, presumptions, factors, standards, guidelines, principles, and analogies).
122 An example of a rebuttable presumption that leads to favorable tax consequences is contained in Treas. Reg. § 1.707-3(d) (establishing a rebuttable presumption that a
taxpayer who complies with the requirements of a rebuttable presumption is quite likely to receive specified tax treatment but may face more risk than a taxpayer who complies with the requirements of a safe harbor. In this way, a rebuttable presumption may lie closer than a safe harbor to the standard end of the rule-standard continuum. However, the difference between safe harbors and rebuttable presumptions should not be overstated. Even safe harbors are not completely safe because a taxpayer who complies with a safe harbor remains subject to overarching anti-abuse rules and doctrines.\textsuperscript{123}

\section*{C. Irrebuttable Presumptions that Lead to Generally Unfavorable Tax Consequences}

An irrebuttable presumption that leads to generally unfavorable tax consequences is merely a different label for a rule prescribing generally unfavorable tax consequences. For instance, the rule under which any individual who is physically present in the United States on 183 days or more in a given calendar year will be treated as a U.S. person for tax purposes creates an irrebuttable presumption that such an individual is a U.S. person for tax purposes.\textsuperscript{124}

\section*{D. Rebuttable Presumptions that Lead to Generally Unfavorable Tax Consequences}

A rebuttable presumption that leads to generally unfavorable tax consequences lies closer to the standard end of the rule-standard spectrum than an irrebuttable presumption that leads to generally unfavorable tax consequences.\textsuperscript{125} Moreover, unlike a safe harbor that is not truly safe because of the potential application of overarching anti-abuse rules and doctrines, an irrebuttable presumption leading to unfavorable tax consequences tends to be more certain because anti-

\textsuperscript{123} See \textit{supra} note 63 and accompanying text.
\textsuperscript{124} For further discussion, see \textit{supra} note 50 and accompanying text.
\textsuperscript{125} An example of a rebuttable presumption that leads to unfavorable tax consequences is contained in Treas. Reg. §1.707-3(c)(1) (establishing a rebuttable presumption that a contribution by a partner to a partnership and distribution from the partnership to that partner are part of a disguised sale if the transactions occur more than two years apart).
abuse rules and doctrines tend to be one-way rules that favor only the government. In other words, an “irrebuttable presumption” that leads to unfavorable tax consequences truly is irrebuttable, whereas an “irrebuttable presumption” that leads to favorable tax consequences may not be entirely irrebuttable. Therefore, in the context of presumptions that lead to unfavorable tax consequences, the distinction between rebuttable and irrebuttable may be more significant than the same distinction in the context of presumptions that lead to favorable tax consequences.

IV. REFORM IMPLICATIONS

The lessons learned from studying the purposes served by safe harbors can inform policy decisions regarding when safe harbors should be enacted and how they should be designed. In particular, five policy lessons can be distilled from the foregoing analysis of safe harbors’ functional purposes. First, rules are best suited to providing certainty. Therefore, when certainty is the overriding objective, lawmakers should opt for a rule. To take a timely example, recently scholars and policymakers have called for more definitive guidance regarding the extent of allowable political campaign activity by tax-exempt organizations. If lawmakers respond to

126 For discussion of the one-way nature of anti-abuse rules, see, e.g., Weisbach, Formalism, supra note 68 at 862 and 877 – 79.

127 See supra notes 18 - 19 and accompanying text. Another current example of an area in which safe harbors are up for debate involves partnership tax allocations. Recently some scholars have focused their attention on taxpayers who operate outside the bounds of the “substantial economic effect” provisions governing partnership tax allocations. See, e.g., Bradley T. Borden, The Allure and Illusion of Partners’ Interests in a Partnership, 79 U. CIN. L. REV. 1077, 1123 - 1127 (2011); Andrea Monroe, Too Big To Fail: The Problem of Partnership Allocations, 30 VA. TAX REV. 465, 506 - 508 (2011) [hereinafter, Monroe, Too Big To Fail]. The “substantial economic effect” provisions have been characterized as a safe harbor. See, e.g., Arthur B. Willis, John S. Pennell, and Philip F. Postlewaite, Partnership Tax ¶ 10.02[2] (“[A]s uncertain as is the determination of substantial for the substantial economic effect test, it is almost a safe harbor as compared to the vagueness of the partner’s interest standard.”) Many partnerships use what are called “targeted allocations” rather than more traditional allocations modeled upon the substantial economic effect safe harbor. In some cases, targeted allocations may not comply with the substantial economic effect safe harbor. In particular, some partnerships that use targeted allocations do not provide for liquidation based on capital account balances. See, e.g., Monroe, Too Big To Fail at 507. This trend toward the use of targeted allocations that may not comply with the substantial economic effect provisions has
these requests, they ought to use rules as their tools of choice rather than safe harbors. Particularly because constraining the IRS’s discretion is a paramount consideration, a rule is a superior instrument given that it limits discretion more thoroughly than a safe harbor.

Second, safe harbors can lead to less arbitrary results than rules. Third, compared to rules, safe harbors are better equipped to furthering the objective of fairness because they are less likely to trap unwary taxpayers. In some contexts, lawmakers ought to prioritize fairness. For instance, when designing tax provisions that affect individual taxpayers who tend to be unsophisticated, lawmakers should be concerned about

caused scholars some concern. See, e.g., Monroe, Too Big To Fail at 509 ("At a minimum, however, target allocations highlight a problematic development in partnership allocations--the affirmative decision to violate substantial economic effect by the very partnerships that such safe harbor was intended to protect."). As scholars and lawmakers examine targeted allocations, some might advocate for converting the substantial economic effect test from a safe harbor into a rule so that partnerships could not use targeted allocations that did not comply with substantial economic effect. Others seeking reform might simply propose guidance regarding when targeted allocations will be respected. Considering the reasons for using safe harbors helps in evaluating proposals governing the treatment of targeted allocations because some taxpayers who use targeted allocations do so for reasons that conform with the rationales for adopting safe harbors, while others might use targeted allocations for less acceptable reasons. In other words, although some partnerships may abandon substantial economic effect in favor of targeted allocations in the hope of successfully engaging in tax-motivated allocations that would not survive scrutiny under the substantial economic effect safe harbor, other partnerships certainly use targeted allocations for benign reasons. Specifically, these other partnerships have strong non-tax reasons for operating outside the bounds of the substantial economic effect safe harbor. In particular, doing so simplifies the process of drafting partnership agreements so that they will be understood by those who are not partnership tax specialists. For these partnerships, maintaining the substantial economic effect test’s status as a safe harbor rather than a rule can foster efficiency by allowing these partnerships to draft agreements in the manner they select for non-tax reasons. Furthermore, even partnerships counseled by cautious advisors readily use targeted allocations for ease of drafting purposes because they intend to allocate tax items in a way that is consistent with the partners’ economic arrangement. Thus, their allocations have a very high chance of being respected under the “partners’ interests in the partnership” standard applicable to partnerships operating outside the safe harbor. Because some taxpayers use targeted allocations for reasons that are consistent with the rationales for using safe harbors rather than rules, lawmakers should not convert the substantial economic effect test from a safe harbor into a rule. Rather, lawmakers should issue guidance regarding targeted allocations that allows partnerships to use them but, at the same time, restricts the ability of partnerships to use them to implement tax-motivated schemes.
the prospect of trapping unwary taxpayers and should utilize safe harbors

to allay their concerns. The choice to prioritize fairness is especially

justifiable because, if a provision affects mostly unsophisticated taxpayers

who do not consider the tax ramifications before acting, lawmakers need

not consider possible distortions -- tax law cannot distort the decisions of

those who do not evaluate tax consequences when making decisions.

Similarly, although to a lesser degree, certainty may be less crucial in the

case of a provision affecting individuals who do not seek advice about

tax law prior to acting.

Fourth, in some cases, lawmakers might seek to distort taxpayers’
decision-making by encouraging taxpayers to operate within given

parameters. In such a case, lawmakers ought to determine where
taxpayers’ non-tax preferences lie. If many taxpayers currently operate

close to but beyond the bounds of where lawmakers wish them to

operate, lawmakers should adopt a rule (or turn a safe harbor into a

permissive safe harbor by enforcing it as if it were a rule). By contrast, if

many taxpayers currently function far beyond the bounds of where

lawmakers wish them to function and are unlikely to move as far as

lawmakers would desire, lawmakers may achieve modest success by

adopting a standard or by enforcing a safe harbor as if it were restrictive

(in other words, by granting favorable tax treatment to some taxpayers

who fail to qualify for the safe harbor). Taking this approach can

encourage taxpayers to move closer to where lawmakers wish them to be,

whereas, when faced with a bright line rule located too far from their

current locations, taxpayers might not bother to change their behavior at

all because the non-tax consequences of obtaining more favorable tax

treatment would be too great.

Finally, in some cases, lawmakers do not desire to use tax

provisions to distort taxpayers’ decisions. In these cases, too, the provision

of choice depends on where taxpayers’ non-tax preferences lie relative to

the bounds of the provision. If many taxpayers operate far from and

outside of the provision’s outer bounds, a rule or a permissive safe harbor

may be less likely to distort taxpayers’ decisions than a standard or a

restrictive safe harbor. If many taxpayers operate within the provision’s

bounds, a rule or a safe harbor may be less likely to distort taxpayers’
decisions than a standard. Finally, if many taxpayers operate close to but

outside of the provision’s bounds, a standard or a safe harbor (particularly

one that is restrictive) may be less likely to distort taxpayers’ decisions
CONCLUSION

Safe harbors pervade many areas of tax law. This Article develops a conceptual framework for understanding safe harbors’ functional purposes. In particular, this Article evaluates whether safe harbors offer any benefits compared to standards and rules. As this Article demonstrates, when lawmakers endeavor to achieve certainty as their chief priority, they ought to adopt rules rather than safe harbors. When fairness is their paramount concern, lawmakers should opt for safe harbors rather than rules. Finally, when lawmakers either affirmatively aim to distort taxpayers’ decisions or wish to avoid distortions, they must examine taxpayers’ current preferences in order to determine what type of provision will most effectively distort (or avoid distorting) taxpayers’ decisions.