ARTICLES AND ESSAYS

THE ECONOMIC SUBSTANCE DOCTRINE

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For more than fifty years, courts have interpreted and applied the tax law with the aid of various "common law" doctrines, such as substance over form, step transaction, business purpose, sham transaction, and economic substance. Notwithstanding this long lineage, the application of the doctrines has always been controversial. Over the years, a wide swath of leading academics and practitioners have debated the wisdom of the doctrines, either in articles or in public fora. The intensity and frequency of this debate has tended to fluctuate over time, with what, for want of a better term, might be called the "tax landscape." In one period, economic and legal conditions encourage aggressive taxpayer positions, the government challenges those positions with common law doctrines, and the debate over the use of the doctrines waxes. The law changes, economic conditions change, taxpayers have less incentive to take aggressive positions, and the common law doctrines fall into relative desuetude.

The recent phenomenon of corporate tax shelters has produced a resurgence in the use of common law doctrines. The Treasury has responded to shelters by stuffing "anti-abuse" provisions into all significant regulations; the anti-abuse provisions are, at core, codifications of common law doctrines.[1] The Treasury and other lawmakers have proposed statutory cures for the tax shelter problem; the cures, like the regulations, are built

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[1] *See, e.g.*, Treas. Reg. §§ 1.701, 1.1374-4, -9 (2000).

around common law doctrines.[2] And in a series of significant cases, courts have accepted the government's arguments and used common law doctrines to deny tax benefits to shelter participants. The common law doctrines are closely related to one another, and no single doctrine has done all the work. That said, the economic substance doctrine has played a particularly important role in the government's fight against corporate tax shelters. Proposed legislation incorporates the doctrine, or portions of the doctrine; the same is true of recently adopted regulations. And in a handful of cases decided within the past year, the economic substance doctrine has been used to deny tax benefits aggregating to many billions of dollars.

These developments have spawned a new debate (or renewed a somewhat dormant debate) over the use of common law doctrines in general, and the use of the economic substance doctrine in particular. As might be expected, those moved to write or speak on the subject have had strong views and ambitious agendas. This does not detract from the merits of their contributions. The literature on these related topics is full of smart observations, as are public presentations. The somewhat partisan nature of the discourse, however, leaves unresolved some basic questions as to the nature of the economic substance and other common law doctrines.

This article tries to fill a void in the literature by providing an overview of the economic substance doctrine. The article is primarily descriptive. The goal is to provide as straightforward an explication of the doctrine as is possible; to explore the doctrine's ambiguities, and to predict, as much as possible, how the doctrine would apply in various real-world situations.

Inevitably, description turns into prescription. The article will from time to time take the position that a particular ambiguity is "best" resolved in one way or another, or that a particular reading of the doctrine is "most reasonable" or "most consistent with underlying intent." To that limited extent, this article is normative. It can be thought of as a guide for administrators deciding whether to invoke the doctrine or for judges forced to interpret the doctrine.

This article does not take a position on broader questions involving the use of common law doctrines in general, or the economic substance

[2] *See* Abusive Tax Shelter Shutdown Act of 1999, H.R. 2255, 106th Cong. § 3 (1999) [hereinafter Tax Shelter Act of 1999] (definition of "noneconomic tax attribute" disallowed under the Act based upon economic substance doctrine); U.S. TREASURY DEP'T, THE PROBLEM OF CORPORATE TAX SHELTERS: DISCUSSION, ANALYSIS AND LEGISLATIVE PROPOSALS, JULY 1, 1999, at 95 [hereinafter TREASURY PROPOSALS] (incorporation of the economic substance doctrine into definition of "tax avoidance transaction" in Administration's proposals).

doctrine in particular. It does not, for example, compare the doctrines to other proposed cures for the problem of tax shelters or statutory ambiguity. Nor does this paper address in any detail a related, though broader and more diffuse, debate over statutory interpretation in tax. It does not, for example, take a position as to whether statutes ought to be read in the "practical" manner suggested by Michael Livingston, or the "purposive" manner suggested by Robert Thornton Smith.[3] The article assumes that, at least for the near future, the economic substance doctrine will be part of the tax landscape, and discusses how that doctrine is likely to be, and ought to be, interpreted.

I. A BRIEF HISTORY AND OVERVIEW OF THE ECONOMIC SUBSTANCE DOCTRINE

The economic substance doctrine has its origin in, and incorporates language from, cases such as *Frank Lyon Co. v. United States*, *Knetsch v.*

[3] *See generally* Michael Livingston, *Practical Reason, "Purposivism," and the Interpretation of Tax Statutes*, 51 TAX L. REV. 677 (1996) [hereinafter Livingston, *Practical Reason*]; Robert Thornton Smith, *Business Purpose: The Assault upon the Citadel*, 53 TAX LAW. 1 (1999) [hereinafter Smith, *Business Purpose*]; Robert Thornton Smith, *Interpreting the Internal Revenue Code: A Tax Jurisprudence*, 72 TAXES 527 (1994). Not surprisingly, interpretive theories in tax are related to and in part derived from a more general literature on statutory interpretation. Livingston's interpretive position is based on the pragmatic, practical approach associated with Eskridge and Frickey. Under that approach, the mode of interpretation will vary from case to case, depending on the age of the statute, the legislative history, the policy issues involved, and so on. *See* WILLIAM N. ESKRIDGE, JR. & PHILIP P. FRICKEY, CASES AND MATERIALS ON LEGISLATION 603–04 (2d ed. 1995); William N. Eskridge, Jr. & Philip P. Frickey, *Statutory Interpretation As Practical Reasoning*, 42 STAN. L. REV. 321 (1990); Livingston, *Practical Reason*, *supra*. Smith, on the other hand, espouses a purposivist approach inspired by, or at least most often associated with, Ronald Dworkin, whom Smith frequently cites. In passages cited by Smith and others, Dworkin argues that the judge may be properly viewed as an author of the statute she is interpreting, albeit an author who owes special deference to the original drafters as coauthors. *See* Smith, *Business Purpose*, *supra*, at 16–19. Other tax scholars who have written on this topic include, notably, Deborah Geier and Lawrence Zelenak. *See* Deborah A. Geier, *Interpreting Tax Legislation: The Role of Purpose*, 2 FLA. TAX REV. 492 (1995); Deborah A. Geier, *Textualism and Tax Cases*, 66 TEMP. L. REV. 445 (1993); Lawrence Zelenak, *Thinking About Nonliteral Interpretation of the Internal Revenue Code*, 64 N.C. L. REV. 623 (1986). Interpretive approaches to tax statutes are discussed throughout this article. *See infra* Part II.A (discussing relationship between economic substance doctrine and interpretive theory). For the most part, however, the doctrine is described without specific reference to interpretive theory. This is because, at least among those who invoke the doctrine, the link between interpretive approach and doctrinal application is not obvious. Those falling anywhere along the spectrum between intentionalist and purposivist, or varying between those points, are apt to apply some elements of the doctrine in quite similar ways. *E.g.*, *infra* Part III.B.2 (noting that the exception for ordinary course of business operations is apt to appeal to those holding a wide range of interpretive positions). The same is true for the limited prescriptive comments in this paper. For example, the argument that the presence of tax benefits, however massive, should not threaten the tax treatment of an investment with an otherwise acceptable before-tax rate of return will (hopefully) be attractive to those with a wide range of interpretive positions.

United States, *Gregory v. Helvering*, and *Goldstein v. Commissioner*.[4] More recent antecedents of the doctrine include cases such as *Lerman v. Commissioner*, *Horn v. Commissioner*, *Kirchman v. Commissioner*, *Rose v. Commissioner*, and *Rice's Toyota World, Inc. v. Commissioner*.[5] For the purposes of this article, it will be useful, if arbitrary, to date the current version of the doctrine from the Third Circuit decision in *ACM Partnership v. Commissioner*.[6]

ACM involved a contingent installment sale (CINS) shelter purchased by Colgate-Palmolive from Merrill Lynch. The shelter, greatly simplified, worked as follows. Colgate-Palmolive and a zero-bracket taxpayer entered into a partnership; the zero-bracket taxpayer was allocated over 80% of all items of gain and loss. The partnership deposited $175 million in interest-bearing accounts and a short while later purchased Citicorp debt for $175 million. Less than a month after the purchase of the Citicorp debt, the partnership sold the debt for $140 million cash and six-year notes pegged to the London Interbank Offering Rate (LIBOR) with a fair market value of approximately $35 million. The transaction was reported under the installment method. The "correct" tax treatment of the transaction would have been (and would be) to reduce the LIBOR notes to their fair value of $35 million, generate a so-called "gain ratio" under the installment method of 0%, and apply that ratio to each payment of principal. The regulations then in effect, however, established a "default rule" that forced the taxpayer to recover basis in equal amounts over the period of contingent payments.[7] Here, this resulted in the recovery of only one-sixth of the basis in the first year. The default rule produced gain of approximately $110 million in the first year—$140 million received less $30 million basis recovered. Pursuant to the partnership agreement, over 80% of this gain was allocated

[4] Frank Lyon Co. v. United States, 435 U.S. 561 (1978); Knetsch v. United States, 364 U.S. 361 (1960); Gregory v. Helvering, 293 U.S. 465 (1935); Goldstein v. Comm'r, 364 F.2d 734 (2d Cir. 1966). *Gregory* is widely seen as a precursor to *ACM Partnership v. Commissioner* and other recent cases in large part because it offered a (relatively) reasoned support for nonliteral interpretation of the tax law. The other cases cited above apply a nonliteralist approach to shelter-like transactions.

[5] Lerman v. Comm'r, 939 F.2d 44 (3d Cir. 1991); Horn v. Comm'r, 968 F.2d 1229 (D.C. Cir. 1992); Kirchman v. Comm'r, 862 F.2d 1486 (11th Cir. 1989); Rose v. Comm'r, 88 T.C. 386 (1987), *aff'd*, 868 F.2d 851 (6th Cir. 1989); Rice's Toyota World, Inc. v. Comm'r, 81 T.C. 184 (1983), *aff'd in part and rev'd in part*, 752 F.2d 89 (4th Cir. 1985). The court in *Rice's Toyota World* separately analyzed the business purpose and objective economic substance of the transaction but did not describe the former as a part of the economic substance test; *Rose* concludes that an approach emphasizing objective factors is preferable in tax shelter cases, but enfolds some consideration of subjective intent in its economic substance test; *Kirchman* and *Lerman* develop the "objective" economic substance test.

[6] 157 F.3d 231 (3d Cir. 1998).

[7] Taxpayers were allowed to petition out of the default rule; this, of course, Colgate-Palmolive declined to do.

to the zero-bracket taxpayer. The remaining five-sixths of basis, approximately $145 million, was left in the $35 million of LIBOR notes. This left a "built-in loss" of $110 million in the LIBOR notes. Had the zero-bracket taxpayer remained in the partnership, it would have recovered more than 80% of this loss, offsetting the income it recognized in the year of sale. Similarly, the capital account of the zero-bracket partner, increased by its share of the $110 million gain in year one, would have decreased by its share of the $110 million loss. In fact, after absorbing the majority of income, the zero-bracket taxpayer was redeemed by the partnership for an accommodation fee, leaving Colgate-Palmolive to recognize all of the built-in loss.

After engaging in the above transaction, the partnership used the proceeds from the Citicorp sale to repurchase long-term debt Colgate-Palmolive had issued some years earlier.

The court in *ACM* scrutinized the transaction under the economic substance test, which it described as containing separate, but interrelated, inquiries:

> The inquiry into whether the taxpayer's transactions [have] sufficient economic substance to be respected for tax purposes turns on both the "objective economic substance of the transactions" and the "subjective business motivation" behind them. However, these distinct aspects of the economic sham inquiry do not constitute discrete prongs of a "rigid two-step analysis," but rather represent related factors both of which inform the analysis of whether the transaction had sufficient substance, apart from its tax consequences, to be respected for tax purposes.[8]

The court defined the objective test as asking "whether the transaction has any practical economic effects other than the creation of income tax losses."[9] The court compared the purchase of Citicorp debt for $175 million and sale of the debt for $140 million and $35 million in LIBOR notes to leaving the entire $175 million in interest-bearing accounts for an additional few weeks and then simply purchasing equivalent LIBOR notes. The court noted that the transitory purchase and sale of Citicorp debt produced only an additional $3,500 in interest income, an amount that was "obliterated" by transaction costs associated with the purchase.[10]

The subjective leg of the economic substance test looks to business purpose. Colgate-Palmolive argued the investment offered a "realistic

[8] *ACM*, 157 F.3d at 247 (citations omitted).

[9] *Id.* at 248 (quoting Jacobson v. Comm'r, 915 F.2d 832, 837 (2d Cir. 1990)).

[10] *Id.* at 249–51.

prospect" of pretax profit; the facts of the case gave the court little pause in rejecting that argument. Colgate-Palmolive also argued that the investment served a nontax purpose, albeit in an indirect way. The purpose of all the transactions, according to the taxpayer, was to repurchase long-term Colgate-Palmolive debt through the partnership.[11] The Citicorp transaction served as an interim investment by the partnership until Colgate-Palmolive could effect that purpose and repurchase its long-term debt. The *ACM* court rejected that argument, holding that the Citicorp debt was unrelated to the subsequent repurchase of the taxpayer's debt.[12]

A nearly identical shelter sold by Merrill Lynch to Brunswick Corporation led to the same result under the same rationale in a more recent Tax Court case, *Saba Partnership v. Commissioner*.[13] The explication of the economic substance doctrine in *Saba* differs from that in *ACM* only in one slight respect: Judge Nims' decision in *Saba* is marginally more explicit as to the relationship between pretax profit and objective economic substance.[14]

In other recent cases, the economic substance doctrine has been used to deny interest deductions on corporate-owned life insurance (COLI) to Winn-Dixie Stores, to deny foreign tax credits to Compaq Computer, and to reallocate income to the United Parcel Service and away from a related foreign corporation.[15]

[11] According to the taxpayer, it had decided that interest rates were to fall, making its long-term debt an expensive method of financing. The debt was to be repurchased through the partnership because such a purchase could remain hidden from public view. Colgate-Palmolive argued that if its purchase of long-term debt were known to "the market," the company would become vulnerable to hostile takeover.

[12] The *ACM* court also noted that the Citicorp transaction was inconsistent with the ostensible rationale for the partnership. As noted *supra* in text and note 11, the partnership was to repurchase the taxpayer's long-term debt primarily because the taxpayer had concluded interest rates were to fall. But the LIBOR notes were effectively interest-only notes (on a notional sum) and would decline in value as interest fell.

[13] 78 T.C.M. (CCH) 684 (1999).

[14] *See id.* at 720–21.

[15] Winn-Dixie Stores, Inc. v. Comm'r, 113 T.C. 254, 294 (1999); Compaq Computer Corp. v. Comm'r, 113 T.C. 214, 225 (1999); UPS of Am., Inc. v. Comm'r, 78 T.C.M. (CCH) 262 (1999).

II. JURISPRUDENTIAL OVERVIEW

A. RELATIONSHIP BETWEEN ECONOMIC SUBSTANCE DOCTRINE AND STATUTORY INTERPRETATION

The federal income tax is, and always has been, based on statute. The economic substance doctrine, like the other common law tax doctrines, can thus perhaps best be thought of as a method of statutory interpretation. A related, though somewhat stronger, claim is that the legislature assumes that long-standing common law doctrines such as economic substance will be used to interpret the statutes it enacts. Under this claim, the doctrines have been implicitly adopted as part of the statute—at least where the statute does not indicate otherwise.

It is in one sense odd to think of the economic substance doctrine as an interpretive method. This is because the doctrine is only loosely connected to more conventional interpretive techniques or approaches. Decisions in which the doctrine is discussed or invoked often contain a separate discussion in which text, intent, and purpose are applied to the issue at hand. The doctrine itself, however, is discussed and applied without significant discussion of text, intent, and purpose. The doctrine fits most comfortably, of course, with a purposivist approach to statutory interpretation. But the doctrine, like its predecessor and related doctrines, in some respects resembles a substantive canon of interpretation; it has been part of the tax law for so long that it is accepted by jurists who would otherwise hew more closely to a textual reading of the applicable statute.[16]

Precisely because the doctrine can be applied without formal discussion of text, intent, or purpose, its application is usually accompanied by, or entwined with, interpretation of the statute using those conventional tools. A transaction attacked through the economic substance doctrine will invariably be defended on the grounds that the transaction is supported by the statute’s text, and generally by some combination of intent and purpose as well. Litigation involving the economic substance doctrine involves related, but in some sense distinct, litigation over the text, intent, and purpose of the statute. The precise relationship between the economic substance doctrine and conventional statutory interpretation is ambiguous. However, it seems clear that a transaction that is clearly supported by the

[16] *See generally* ESKRIDGE & FRICKEY, *supra* note 3, at 513–631 (role and use of substantive interpretive canons); Cass R. Sunstein, *Interpreting Statutes in the Regulatory State*, 103 HARV. L. REV. 405 (1989) (expansive view of substantive canons). Some substantive doctrines, at least, find favor even among textualist jurists. ESKRIDGE & FRICKEY, *supra* note 3, at 655.

text, intent, and purpose (or whatever combination that comports with the judge's interpretive stance) will withstand judicial scrutiny regardless of whether it otherwise meets the economic substance test.

B. RELATIONSHIP BETWEEN THE ECONOMIC SUBSTANCE DOCTRINE AND OTHER COMMON LAW DOCTRINES

As noted throughout this article, the economic substance doctrine is closely related to common law doctrines of sham transaction, substance over form, business purpose, economic profit, and step transaction. Detailed discussion of these other doctrines is beyond the scope of this article. However, two comments about the relationship between the economic substance doctrine and other common law doctrines may be useful.

First, the economic substance doctrine to some extent incorporates other common law doctrines. This is most apparent in the "subjective" leg of the doctrine, which explicitly incorporates the business purpose doctrine. The business purpose doctrine has been criticized for focusing on motives underlying a transaction, rather than effects of a transaction. The economic substance doctrine blunts this criticism by explicitly tying consideration of motives (the subjective leg of the doctrine) to effect (the objective leg of the doctrine).[17] The objective leg of the doctrine to some extent incorporates sham transaction, economic profit, and substance over form doctrines.

Second, the differences between the doctrines are apt to be smaller than first imagined. As noted above, the doctrines are limited by the constraint, so to speak, of conventional statutory interpretation. Equally important, the doctrines are all, in crucial respects, ambiguous or incomplete. Sensible administration requires a set of rules—for want of a better term, "application rules"—to resolve ambiguities and fill in missing elements of the doctrine. The application rules of the economic substance doctrine are, in one sense, the subject of this article. In general, the rules of application are apt to be quite similar for all of the doctrines.

III. OBJECTIVE ECONOMIC SUBSTANCE

The objective leg of the economic substance test requires that a transaction have some nontax effect. This leads to the obvious question—how much effect is enough? It may seem sensible to begin with this

[17] *See* discussion *infra* Part IV.A.

question, and then explore other dimensions of this leg of the test. Before grappling with this question, however, it will be useful to set forth some additional rules that limit the doctrine.

A. EXCLUSION FOR LEGISLATIVELY "INTENDED" TAX BENEFITS

1. *Generally*

The primary limitation on the objective economic substance doctrine has been adverted to above: The doctrine cannot apply where a sensible reading of text, legislative intent, and purpose suggest it should not apply. Consider, for example, a decision by a corporate taxpayer to invest in housing subject to low-income tax credit. The tax credit was enacted to stimulate investment in low-income housing. A taxpayer who, at the margin, makes the investment solely because of tax reasons is presumably doing just what the lawmakers who enacted the legislation would have wished. (Legislation influences investment only by changing behavior of taxpayers at the margin). Yet the investment is necessarily one that does not have a favorable before-tax return.

As is perhaps obvious, the above example can be generalized to apply to nearly any investment. Cost-recovery rules vary wildly among various assets and natural resources. An investment in an asset subject to favorable cost recovery may be just profitable enough to undertake on an after-tax basis but provide a negative return on a before-tax basis. The same can be said for investments in industries (e.g., life insurance) that may be subject to favorable tax rules. Applying the economic substance test, in a straightforward way, to these sorts of investments would be insupportable.

Some tax rules favor certain investment vehicles rather than investments. Partnerships and S corporations are taxed more favorably than C corporations. Taxpayers who qualify for all three forms of business organization can chose one form over another solely for tax reasons.

2. *Interpreting Text, Intent, and Purpose*

The preceding discussion assumed that text, intent, and purpose are easy to decipher and congruous. That, of course, will not always or even generally be the case. Text may point in a different direction than does purpose or intent, and judges or policymakers may have an interpretive theory or practice that favors one over the other.[18] A particular approach,

[18] *See supra* note 5.

even if agreed upon, may not yield an obvious answer. One might interpret a statute according to legislative intent and then be faced with the task of collecting shards of conflicting evidence into a single intent;[19] a modern-day variant of that approach might further pose the counterfactual question of what an enacting legislature that did not think of the issue at hand would have intended had they thought of that issue.[20] Similar ambiguities beset the textualist.

It is easy to come up with tax-shelter-related examples in which intent and purpose, and perhaps even text, do not point in any obvious direction. Consider, for example, the following variant on the so-called "basis stuffing" shelter. Parent is a Fortune 500 company with a wholly-owned subsidiary. Subsidiary engages an investment bank to help raise 100*x* through issuance of conventional debt. The investment bank instead convinces Subsidiary to accept 15*x* cash from Parent and securities worth 85*x* from a foreign taxpayer. The foreign taxpayer is located in a tax jurisdiction that does not tax gains on securities or allow deductions for losses on securities. The securities have a basis in the zero-bracket taxpayer's hands of 200*x*. The parties take the position that the transfers qualify under § 351, so that Subsidiary receives a substituted basis of 200*x* in the securities.[21] Subsidiary sells the securities and takes a loss of 115*x*. The zero-bracket taxpayer is compensated for the tax value of its contribution by receiving 90*x* of Subsidiary stock, 5*x* more than the securities are worth absent tax considerations.

The shelter, if blessed, could quickly erode corporate tax revenues. All high-basis, low-value property would migrate to domestic corporations. One can imagine a decision that sensibly rules the hoped-for tax consequences are inconsistent with the statute's purpose, perhaps with its intent,[22] and perhaps even with the text.[23]

[19] *See* OTTO HETZEL, MICHAEL LIBONATA & ROBERT WILLIAMS, LEGISLATIVE LAW AND PROCESS 438 (2d ed. 1993) (listing twenty indicia of legislative intent, including floor debate, conference committee reports, actions taken, and reports, hearings, and debates on prior related legislation).

[20] This "imaginative reconstruction" is associated with Roscoe Pound and to some extent with Richard Posner.

[21] I.R.C. § 362(a) (1994). This transaction is discussed in somewhat more detail in Joseph Bankman, *The New Market in Corporate Tax Shelters*, 83 TAX NOTES 1775, 1777 (1999).

[22] Intent for this purpose would presumably be defined, imaginatively, as the intent the legislature would have had toward the transaction had it thought of the transaction.

[23] This would be the case under the (doubtful) rationale that the transaction did not comply with the ordinary meaning of contribution but was instead a sale.

On the other hand, appreciated property contributed by low-bracket taxpayers to high-bracket corporations in § 351 transfers is taxed at the high corporate rate when sold by the corporation. That is simply the way the statute operates. Perhaps it is most sensible to assume the statute should, and was intended to, operate symmetrically. The problem of contributions of property designed to produce losses at the corporate level is addressed in various statutes, including the liquidation provisions under § 336. Should we assume that in enacting these provisions Congress intended to bless other forms of producing the sale result?

In theory, the "exception" for benefits that comport with text, intent, and purpose might render the economic substance doctrine useless. In practice, that has not proven to be the case. The current wave of tax shelters fail the economic substance test but do not find much support under intent- and purpose-based examinations of the underlying statute and, in some cases, do not survive even a careful text-based reading of the statute.

B. Definition of the Transaction: Transactions Linked to Ordinary Business Operations

1. *Generally*

The economic substance doctrine requires that the events giving rise to a particular tax position must have objective economic substance, but does not tell us which of many interrelated events ought to be lumped together and measured for economic substance. In general, the greater the number of events lumped together, the greater the likelihood that a tax position will reflect changes in nontax attributes.[24] In theory, by expanding or contracting the number of related events, a decisionmaker could reach virtually any result it wanted under the doctrine. In practice, some tax positions will seem to correspond naturally with a discrete number of events or transactions. Moreover, courts have already put some flesh on this part of the doctrine by showing a willingness to lump together transactions connected to a taxpayer's ordinary business operations, but treat as discrete each element in tax shelters.

Some idea of the issues involved, and the courts' treatment of those issues, can be gleaned from the role *Cottage Savings Ass'n v.*

[24] This will obviously not be the case where a taxpayer has entered into a hedge, so that one transaction offsets another.

Commissioner has played in recent case law.[25] As readers of this article no doubt recall (or at least once knew), the taxpayer in *Cottage Savings* had written mortgages that (due to a rise in interest rates) had fallen in value. The taxpayer could not sell its mortgages without reporting a loss for accounting purposes; such a loss would have threatened its ability to operate under then-current banking regulations. However, the taxpayer was allowed, under banking regulations, to swap its mortgages without recognizing an accounting loss and subsequent regulatory closure. The taxpayer swapped its mortgages for mortgages of equivalent value and claimed a loss for tax purposes. The individual mortgages received were “different” from those swapped; that is, they secured indebtedness from different individuals secured by different property. But the basket of mortgages received was as an economic matter identical in every relevant respect to the basket of mortgages swapped. The government argued that the swap should not be treated as a realization event because it lacked economic substance. The Court held that the mortgages, though as a basket economically similar, were materially different because they embodied legally distinct entitlements, and upheld the loss.

The taxpayer in *ACM* argued that its losses on the sale of the Citicorp debt ought to be allowed for the same reason the losses in *Cottage Savings* were allowed: The Citicorp debt embodied legally distinct entitlements from the combination of cash and LIBOR notes received in exchange. The court in *ACM* responded to the argument as follows:

> The distinctions between the exchange at issue in this case and the exchange before the Court in *Cottage Savings* predominate over any superficial similarities between the two transactions. The taxpayer in *Cottage Savings* had an economically substantive investment in assets which it had acquired a number of years earlier in the course of its ordinary business operations and which had declined in actual economic value by over $2 million . . . .
>
> While the dispositions in *Cottage Savings* and in this case appear similar in that the taxpayer exchanged the assets for other assets with the same net present value, beneath this similarity lies the more fundamental distinction that the disposition in *Cottage Savings* precipitated the realization of actual economic losses arising from a longterm, economically significant investment, while the disposition in this case was without economic effect as it merely terminated a fleeting and economically inconsequential investment . . . .[26]

[25] 499 U.S. 554 (1991).

[26] *ACM*, 157 F.3d at 251.

Thus, the swap in *Cottage Savings*, while economically insignificant in itself, was tied to ordinary business operations, and what was measured for substantial economic effect was not just the swap, but the business operations to which it was tied. The sale of Citicorp debt was not tied to ordinary business operations, and so it was considered in isolation for the purposes of determining economic effect.[27] *Cottage Savings* was raised by the taxpayer, and distinguished by the court, in much the same way later in *Saba*.[28]

2. *Down the Slippery Slope*

The treatment of *Cottage Savings* by the *ACM* and *Saba* courts suggest that transactions tied to ordinary business operations will be favorably treated under the economic substance doctrine. The favorable treatment for tax-motivated transactions tied to ordinary business operations (the "ordinary business exception") raises obvious line-drawing questions, to wit: How closely must the tax-motivated transaction be tied in order to qualify for such treatment, and what constitutes ordinary business operations? Consider, for example, the following variant of the CINS transaction. Colgate-Palmolive finds itself in a joint venture with a corporation with otherwise unusable net operating losses. The principal business of the venture is sold. The sale price includes contingent payments and the contingent installment sales regulations in effect at the time of the original transaction are still in effect. Neither the joint venture, the decision to sell the principal business, nor the decision to sell for contingent payments is tax motivated. The default provisions in the contingent installment sale regulations will produce a noneconomic tax gain in the year of sale, and a noneconomic tax loss in later years. Colgate-Palmolive is about to petition for relief from that provision under the regulations when it realizes that it can turn the rules to its advantage—but only if it redeems the interest of its joint venturer after the joint venturer has "absorbed" a share of the noneconomic gain in the first year. Presumably, the company can redeem the joint venturer and claim the loss, unimpeded by the economic substance doctrine.

Suppose now that the facts are the same as above except that the decision to require some form of contingent payment in the sale, as well as the decision to redeem out the joint venturer, is tax motivated. Will the

[27] *Cottage Savings* could be distinguished from *ACM* for other reasons as well. One key difference—that *Cottage Savings* involved realization whereas *ACM* involved loss generation—is discussed in Part III.C *infra*.

[28] *See Saba*, 78 T.C.M. (CCH) at 715–17.

events still be compressed into a single event (operation and disposition of a business), and so meet the economic substance doctrine? What if the sale itself is tax motivated? If Colgate-Palmolive stuffs new assets (or cash with which to purchase assets) in an existing joint venture, for the primary purpose of selling the assets in a manner that takes advantage of the regulations?

In the preceding examples, the taxpayer has an ordinary business to which, perhaps, tax-motivated transactions may be tied. Suppose, though, that the tax-motivated transaction is part of an investment, unconnected to any business. Is the exception for ordinary business operations unavailable? Or is the investment treated as a separate business, so that the question turns on how closely the tax-motivated transaction is tied to the rest of the investment? There is obviously no single right answer to that question. As a predictive matter, one would expect courts to be more apt to link transactions that arise out of regular business operations, more suspicious of tax-motivated transactions carried out in separate investments, and less likely to link transactions that comprise such investments.

3. *Evaluation*

The above analysis suggests that the same transactions, considered in isolation, will be treated differently. An aggressive play on the contingent sales regulations, for example, works if it is discovered "accidentally" in the course of ordinary business operations but does not work if it is part of a prearranged plan that is unrelated to business operations. This produces results that are in one respect arbitrary. These results, however, may be justified on pragmatic grounds.

A rule that allows taxpayers to take advantage of loopholes that naturally present themselves in the course of business operations will be expensive to the federal coffers, but that cost will be limited to the number of "naturally present" loopholes. A rule that allows taxpayers not only to take advantage of loopholes but to manufacture circumstances in which they arise would be ruinous to the fisc.

Under that latter case, one might expect the creation of a tax-shelter industry devoted to discovering and marketing loopholes. The tax-shelter industry would be able to amortize costs over many taxpayers, thus greatly reducing the per-taxpayer cost of locating shelters, finding zero-bracket parties with which to take advantage of shelters, limiting economic risks associated with shelters, and so on. In theory, a single shelter, developed and marketed by a promoter, could eliminate a substantial portion of corporate income.

As readers of this article are no doubt aware, to some extent all of this has already occurred. Tax shelters have been a growth industry for financial intermediaries; these intermediaries have dramatically expanded shelter opportunities for corporate taxpayers; and while corporate tax revenues have risen with the booming economy, shelters have removed billions from government coffers. The economic substance doctrine, with its implicit exception for tax-motivated transactions closely tied to ordinary course of business operations, and supplemented by more effective enforcement, higher penalties, or both, would substantially limit shelter use. Taxpayers would still be allowed to exploit unintended snafus in the law and regulations, but that exploitation would be limited to those flaws that arise in the ordinary course of business.

A related argument for the ordinary course of business exception centers around political-process concerns. The tax rules are not self-executing; that is, the rules do not provide a single, apparent result for every economic transaction. Given that reality, it would be desirable, perhaps, if taxpayers could select the rule that reduces their tax burden, without worrying about whether the rule best comports with underlying intent or a multi-faced common law doctrine. So long as rules cannot be exploited in mass-marketed shelters, it will be economically feasible to give taxpayers that choice. Ambiguities and snafus in regulations and statutes can be addressed by amending the relevant statutes or regulations, without retroactive effective dates. The advent of marketed shelters changes that calculus.

The ordinary course of business exception can also be defended on efficiency grounds. The welfare loss from shelters is not simply derived from the reduced tax revenue and cost of replacing that revenue but also includes the resources devoted to the shelter industry. Companies pay high fees to promoters and high transaction costs to manufacture circumstances required by shelters. Shelters also eat up internal corporate resources that are not easily monetized, such as employee time. These costs are avoided if taxpayers are allowed to exploit only those drafting errors that come up in the ordinary course of business. For these and other reasons, one suspects that the ordinary course of business exception will appeal to most of those who apply the economic substance doctrine, regardless of their more general interpretive stance or their position on other elements of the doctrine.

The sanguine view of the ordinary course of business exception is subject to one important caveat: It assumes that it is impossible or at least extremely difficult for taxpayers to change behavior and manufacture shelter opportunities and still stay within the boundaries of their ordinary course of business. This would be the case if there were a clear-cut divide between manufactured shelters and the ordinary course of business, and if taxpayers were interested only in shelters that were shorn of business risks. Suppose, instead, that the definition of ordinary course of business is ambiguous, but not so ambiguous as to include marketed shelters. A company may now be tempted to change its actual business operations and the costs of that change may be greater than the costs of purchasing a "ready-made" shelter from a financial intermediary. Consider, for example, a variant of the CINS shelter discussed in subsection 1, above: Colgate-Palmolive has an operating joint venture with a zero-bracket taxpayer when it "discovers" a flaw in the contingent sales regulations. Colgate-Palmolive exploits the flaw by selling the venture for a contingent amount and redeeming the joint venturer out in the year following the sale. It is quite possible that the social waste entailed in selling an operating business would be greater than the waste entailed in the Merrill Lynch shelter Colgate-Palmolive actually purchased. The ability to manufacture shelter opportunities while staying within (but just barely within) the ordinary course of business would also limit the fiscal benefits of the ordinary course of business exception. And at least one leading practitioner has claimed that a company that correctly manages its business operations, tax-wise, need never purchase a marketed shelter to offset realized gain.

At present, the dynamics of corporate tax planning seem to support the positive view, expressed above, of the ordinary course of business exception. Companies are willing to take aggressive tax positions on transactions done for nontax reasons; companies are also increasingly willing to pay for shelters that do not involve business risk. Companies do not, however, like to engage in risky enterprises that offer tax benefits as a primary return. The ordinary course of business exception, if enforced in a strict fashion, and buttressed by effective enforcement and penalties, would significantly limit revenue loss to the federal coffers. It also seems likely, though less certain, that this leg of the doctrine would reduce social waste.

C. ABSURDITY OF RESULT

It is commonsensical to think that the application of the doctrine will depend in part on how much, if at all, the taxpayer's position seems to conflict with the "correct" tax treatment of a particular transaction. All else being equal, positions that seem absurd on their face are more likely to fail the economic substance test. If, and to the extent, this surmise is correct, it is interesting to speculate on whether realization-related shelters, which generally provide deferral of economic and otherwise taxable gain, will be more leniently treated than shelters that provide a tax loss on an economically break-even transaction—the so-called "loss generators."

For the most part, realization is wholly elective: Taxpayers can choose whether and when to recognize gain or loss on an asset simply by timing the sale of the asset. Occasionally taxpayers find themselves wishing to retain ownership of an asset for economic or regulatory purposes yet still recognize a loss for tax purposes (as in *Cottage Savings*), or to disinvest in an asset for economic or regulatory purposes and defer gain. There are of course rules designed to prevent this sort of result.[29] But suppose a taxpayer negotiates around these rules. The realization doctrine is inherently arbitrary, and commonly manipulated by taxpayers, in above-board fashion. Does that mean that any application of a multi-faceted standard such as economic substance is inappropriate?

The answer to this question is probably no. The economic substance doctrine will play a role in some realization-related cases. But the fact that the result in those cases is apt to appear less egregious than the result in loss generator cases is likely to influence the application of the doctrine. An example of the differential treatment of the realization-related tax positions might be the treatment of *Cottage Savings*, both by the Supreme Court in deciding the case and by more recent courts in distinguishing the case. As noted above, the court in *ACM* distinguished the facts in *ACM* from the facts in *Cottage Savings* by invoking what this article has termed the ordinary course of business exception. The mortgages swapped in *Cottage Savings* were tied to mortgages written in the ordinary course of business, and so the economic substance test is applied to the writing, as well as the swap, of the mortgages. Cottage Savings' swap thus meets the economic substance test through the aggregation of linked events.

The Court in *Cottage Savings* gave a different rationale for the decision: that the exchanges qualified under the literal language of the statute. The government's claim that the exchanges lacked economic substance was dismissed without significant discussion. Here, the fact that the taxpayer took a somewhat reasonable position in an area in which the

[29] *See, e.g.*, I.R.C. § 1091 (1994) (wash sales rules); I.R.C. § 1259 (West Supp. 2000) (constructive sales rules).

law is arbitrary led the Court simply to reject the application of the economic substance doctrine.

D. LOST TAX REVENUE AND OTHER INTANGIBLE COSTS

An economic substance case that involves a publicly marketed shelter and a billion dollar price tag is hard to defend as taxpayer's counsel—on that most tax lawyers would agree. This predictive statement can be explained on a number of grounds. A taxpayer will generally have a harder time establishing a business purpose for a marketed shelter than for a nonmarketed shelter. A marketed shelter will stick out from a taxpayer's ordinary business operations, so the economic effect of the shelter is likely to be judged in isolation, rather than together with linked business transactions. At the core, however, one suspects that courts (and certainly) administrators will treat marketed shelters worse on pragmatic grounds. Marketed shelters pose a greater threat to the federal coffers. Such shelters can impose intangible costs as well. The shelters of the early 1980s were thought to erode confidence in, and compliance with, the tax law. The same can be said, perhaps, of today's corporate tax shelters.

E. FINANCING TRANSACTIONS

Many recent and current tax shelters are financing-related. Step-down preferred, for example, enabled taxpayers effectively to deduct not only the interest on debt, but the principal as well;[30] the basis-stuffing shelter described in Part III.C gives taxpayers capital as well as a loss; the same can be said for the so-called § 357(c) shelters.[31] In general, the economic substance is not an effective tool with which to challenge these forms of

[30] Step-down preferred is described in Bankman, *supra* note 21, at 1779.

[31] In these shelters, a domestic corporation would accept a contribution of property from a foreign person not subject to U.S. tax jurisdiction. The property would be subject to a lien in security for debt incurred by the contributor; in accepting the property, the corporation would become secondarily liable on the debt secured in part by the lien. The amount of the debt would typically be many times the value of the property. For example, the property might be worth $1 million and the debt $30 million. The debt would be fully secured by other property still held by the contributor and the contributor itself would be creditworthy. The parties would take the position that the contribution was governed by § 351. In accordance with a revenue ruling, the parties would further take the position that the contributor recognized gain for tax purposes equal to the entire amount of debt now guaranteed by the corporation—even though the contributor remained primarily liable for the debt and the debt was fully secured by other property of the contributor. The recognition of gain would be of no event to the contributor who, as noted above, was not subject to U.S. tax. But, based on that hypothetical realization, the parties would take the position that the corporation ought to get a step up in basis to reflect gain recognized on transfer. The net result in this example would be a $30 million basis for property worth $1 million.

shelters. The reason for this is that financing is naturally linked to the use of proceeds from the financing, and that the latter provides sufficient business purpose. It is for this reason that statutory approaches to the tax-shelter problem that adopt some variant of the economic substance doctrine generally provide other tests for financing arrangements.[32]

F. How Much Profit Is Enough?

1. *Generally*

Having discussed some of the application rules of the objective economic substance doctrine, it now seems appropriate to address the question raised at the start of this section: How much substance is enough? If substance is measured by pretax rate of return, what rate of return is high enough to give a transaction substance?

Unfortunately, there is no clear answer to this question under existing doctrine. This is not because courts have come out differently on the issue; rather, it is because no tax shelter case has yet involved any positive return, once transaction costs are taken into account.[33]

What should the answer to this question be? One plausible rule would be to require only the bare minimum present value expected return required by similarly situated taxpayers for investments with similar risk characteristics. The rule could be made less ambiguous by eliminating the

[32] *See* Tax Shelter Act of 1999, *supra* note 2, § 3; Treasury Proposals, *supra* note 2, at 96.

[33] The "how-much-is-enough" issue is discussed at greatest length by the court in *Saba*. There, the court concluded:

> Relatively modest profits are insufficient, standing alone, to clothe the disputed CINS transactions with economic substance. In particular, even assuming for the sake of argument that the partnership reasonably could have expected profits of up to $10,800,000 on a 5-year investment in the LIBOR notes, such profits would be inconsequential when compared with the capital losses of approximately $170,000,000 that the CINS transactions were designed to generate for Brunswick.

Saba, 78 T.C.M. (CCH) at 721. This passage suggests that the court favored an approach that compared tax benefits to pretax profits—an approach consistent with the Treasury Department's shelter proposals but inconsistent with most case law on point.

Immediately after offering the "benefits-to-pretax-profits" approach, the court in *Saba* took a different approach:

> A transaction has economic substance when it is the kind of transaction that some people enter into without a tax motive, even though the people fighting to defend the tax advantages of the transaction might not or would not have undertaken it but for the prospect of such advantages—may indeed have had no other interest in the transaction.

Id. at 722 (quoting Yosha v. Comm'r, 861 F.2d 494, 499 (7th Cir. 1988)). The reference to "people . . . without a tax motive" in the quote is unclear. One possibility—that a transaction must offer a return sufficient to attract a zero-bracket taxpayer in order to pass muster—is discussed *infra* in text following this note.

"similarly situated" requirement. In that case, a taxpayer could justify its position so long as it could show that some taxpayers, somewhere, would have found the pretax return it had received to be attractive.

A significant drawback to the "comparison-with-other-investment" rule outlined above is hinted at in Part III.A, above. Tax rates vary across asset types and investment vehicles. If tax benefits are fully embedded in asset price, then, at the margin, investments in all tax-favored assets should provide a subpar and perhaps even negative pretax return. To illustrate, suppose that a taxpayer justified a shelter purchase that provided a negative before-tax return on the grounds that similarly situated taxpayers had made investments in low-income housing that provided an equivalent negative return.

One could of course distinguish the low-income housing investment on the grounds that low-income housing is legislatively favored while the taxpayer's investment presumably is not. But that form of distinction becomes more problematic as the tax-favored treatment of the comparison investment becomes less a matter of explicit legislative intent. May the taxpayer offer investments in depreciable machinery as the comparison investment? A remainder interest in a safe income stream? The problem is compounded by the difficulty of determining the actual return. A interest-bearing checking account, for example, might be taken as an example of a non-tax-favored asset that might be used as a comparison investment. However, as is by now well known, checking accounts offer tax-free return in the form of checking and other services. The return on a checking account is thus tax favored.

The problem of comparisons with tax-favored assets could be avoided by requiring comparison with a fully taxed asset; one might then require a pretax return equal to the lowest plausible return an investor would require from a fully taxed asset. The same result could be obtained by using as a comparison the lowest return sufficient to attract investment from a zero-bracket taxpayer. The downside to this approach is that it assumes the comparison asset is fully taxed, when, in fact, the investment the taxpayer would have made had it not purchased a shelter might well have been tax favored.

A conservative, but perhaps workable, approach would be to specify a relatively low (and admittedly arbitrary) rate as a hurdle rate for transactions subject to challenge under the economic substance test. For example, one might establish a safe harbor for investments that provide an expected pretax return equal to some percentage (less than 100%) of the tax-exempt rate.[34] This would be a taxpayer-friendly rule: It would the give the taxpayer the benefit of comparison with a safe, tax-favored asset. Another attractive approach, discussed below, is to look at the return provided by other (nonshelter) investments of the taxpayer.

The analysis thus far has assumed that a taxpayer has actually made an investment in an asset; that is, that the taxpayer has placed some of its money at risk. In many of the shelters thus far litigated, however, that has not been the case. Not only were the returns, after transaction costs, negative, but the taxpayer had hedged away the possibility of any upside or downside. If a negative expected return has no economic substance, then, perforce, the same is true for a negative expected risk-free return.

Suppose, though, that a taxpayer produces a positive expected risk-free return. Suppose, in the *ACM* case, Colgate-Palmolive had held the Citicorp debt for two years and held the LIBOR notes received in exchange for the debt for a like period. Assume, however, that Colgate-Palmolive had a history of investments in Treasury bills and notes, and had hedged out most or all of the risk associated with holding the Citicorp debt and LIBOR notes. Assume finally that the interest on the debt instruments exceeded transaction costs and produced a return sufficient to meet the low hurdle rate suggested above. Now the investment in Citicorp debt that gives rise to the loss may lack economic substance not because the pretax return is too low, but because the taxpayer has not actually made that investment.

A court in that situation could reach the same bottom-line result by adopting Treasury bills and notes as establishing the required pretax rate of return. Here, the decision to use a combination of Citicorp debt, LIBOR notes, and hedges to obtain the return and risk characteristics offered by government debt serves no business purpose: The taxpayer could have gotten that same return with lower transaction costs had it simply continued its prior practice of investment in government debt.

Existing investments might be adopted as the natural comparison investments even in situations in which the taxpayer does not hedge out the risk of the shelter. In situations in which the taxpayer has a consistent pattern of nonshelter investments, those nonshelter investments offer a natural hurdle rate against which to measure the economic return from shelter investments.[35]

[34] One could use the same rates as provided for in I.R.C. § 382(f).

[35] The court in *ACM* implicitly adopted this approach in comparing the return on the Citicorp transaction from the return available through its prior investment.

The Treasury has included a variant of the economic substance test in its proposed legislation. Under that variant, tax benefits would be measured against pretax profit.[36] One suspects that any intelligent application of the economic substance test requires some consideration of the relationship between tax benefits and nontax benefits. But basing a test primarily on the relationship between the benefits raises problems of its own. Suppose, for example, that a transaction offers a healthy pretax rate of return but even greater tax benefits. Ought the transaction to be at risk under the economic substance test? The better view is that a transaction that produces a substantial pretax return is immune from challenge on economic substance grounds.

Some investments are intended to produce intangible business benefits. For example, an investment might be designed to discourage a hostile takeover, or increase customer goodwill. These benefits, no less than any other benefits, must be taken into account when determining whether a transaction has economic substance.

IV. SUBJECTIVE LEG OF THE ECONOMIC SUBSTANCE DOCTRINE

A. RELATIONSHIP BETWEEN THE SUBJECTIVE AND OBJECTIVE TESTS

As noted in Part II, above, the economic substance doctrine has both an objective and subjective leg. Courts have without exception insisted that the two legs are interrelated;[37] however, courts have also stated that a transaction that has objective economic substance will be respected for tax purposes, regardless of the taxpayer's motivation.[38] Courts are split as to whether a transaction that has subjective but not objective economic substance should be respected for tax purposes.[39] In practical terms, then, the tests are interrelated in those cases in which evidence as to objective

[36] The Treasury's approach is discussed and defended in TREASURY PROPOSALS, *supra* note 2, at 162–65. Robert Thornton Smith has also suggested a comparison test. Under this test, the tax-rate-adjusted pretax yield would be compared to the full after-tax yield. Smith, *Business Purpose*, *supra* note 3, at 25. The critique of the Treasury approach—that an investment with an acceptable economic return should be upheld notwithstanding tax benefits—applies to Smith's approach as well.

[37] ACM P'ship v. Comm'r, 157 F.3d 231, 247 (3d Cir. 1998); Saba P'ship v. Comm'r, 78 T.C.M. (CCH) 684, 713–15 (1999); UPS of Am., Inc. v. Comm'r, 78 T.C.M. (CCH) 262, 270 (1999).

[38] *ACM*, 157 F.3d at 248.

[39] *Saba*, 78 T.C.M. (CCH) at 713–15 (comparing Horn v. Comm'r, 968 F.2d 1229, 1237 (D.C. Cir. 1992), with Kirchman v. Comm'r, 862 F.2d 1486, 1492 (11th Cir. 1989)). Robert Thornton Smith would uphold a transaction that meets the subjective but not objective leg of the economic substance test. Smith, *Business Purpose*, *supra* note 3, at 26–27.

intent is inconclusive. In such cases, strong but not dispositive evidence of objective substance can offset weak evidence of subjective substance, and vice versa.

B. DEFINITION OF SUBJECTIVE ECONOMIC SUBSTANCE

The subjective leg of the economic substance doctrine looks to the taxpayer's expectations and motives: The leg is similar, if not identical, to the "business purpose" doctrine, and is sometimes simply referred to as the business purpose requirement. As explained by the court in *Compaq Computer*, "[t]o satisfy the business purpose requirement of the economic substance inquiry, 'the transaction must be rationally related to a useful nontax purpose that is plausible in light of the taxpayer's conduct and . . . economic situation.'"[40]

How significant must the nontax purpose be? That question is left unanswered by the courts, for the same reason that the cognate question in the objective leg of the economic substance test is left unanswered: The transactions thus far challenged by the government have served no plausible nontax purpose.[41]

Perhaps the most reasonable rule would be to peg the required expectations to the required return or business purpose in the objective leg of the doctrine. Thus, if in a particular case, a 3% riskless pretax return is thought required to imbue a transaction with objective economic substance, an expectation of the same return would meet the subjective leg of the doctrine.

C. CRITIQUE

It is, of course, impossible to know a taxpayer's (or anyone else's) actual subjective intent. The subjective intent or business purpose doctrine must inevitably look to objective indicia of intent: contemporaneous documents, evidence of meetings, and the like. These indicia may be subject to manipulation. A primary criticism of the business purpose test is that it leads to the creation of false or misleading documents that evidence nontax motives. Promoters supply corporations with reams of paper on the

[40] Compaq Computer Corp. v. Comm'r, 113 T.C. 214, 224 (1999) (quoting ACM P'ship v. Comm'r, 73 T.C.M. (CCH) 2189, 2217 (1997)).

[41] Taxpayers in decided cases have argued that the transactions ought to be tied to other transactions with nontax purpose and effect. The conclusion in the text—that the transactions had no nontax purpose—implicitly adopts the courts' determinations that the transactions were appropriately viewed in isolation. *See* "scope-of-transaction" discussion *supra* Part III.B.

ostensible business benefits of a particular shelter; the corporation approves the purchase in meetings whose notes stress such benefits—all for a shelter that in truth is purchased only for its tax benefits.

What is astounding, thus far, is how few steps shelter-participants in litigated cases took to establish nontax motives for their investment. Far from creating a false record of due diligence and expectations of pretax profit, participants left a paper trail that virtually ruled out any inference of nontax motives. It may be that the first set of shelter-participants simply did not anticipate courts would reach consensus around the economic substance doctrine and reject their position in part for lack of business purpose. If that is the case, the criticism of the subjective economic effect doctrine is left intact. The next generation of shelter-participants will leave a paper trial that establishes nontax reasons for their investments.

It may be, however, that the creation of a false paper trial is harder than it sounds. Administrators and courts are properly skeptical of documentary records written and controlled by taxpayers and shelter promoters. It may be difficult to generate a plausible paper record to support a transaction that on its face offers only tax benefits. In addition, most shelters are purchased by large corporations, and require the approval and input of a number of employees and officers. As noted throughout this article, corporate purchasers generally will not purchase a shelter if it carries with it any significant business risk. It may be difficult for a promoter to sell a shelter to a corporate officer if it is accompanied by written materials that emphasize nontax benefits and risks; difficult for a corporate officer who favors the shelter to sell the shelter to her colleagues if it is so accompanied by such written materials; and so on. It is possible, of course, that corporate officers would orally describe a shelter as having little or no business upside or downside in internal meetings but create a written record to the contrary. No doubt some of this occurs; there generally will be a common understanding of the shelter that is not reflected in written records. But this mild form of deception or dissembling will be assumed by administrators and courts and for that reason will not be particularly useful. Corporate officials will be reluctant to go beyond this. For example, if a shelter with little nontax purpose is honestly discussed in a corporate meeting, an employee taking notes or minutes of that meeting may describe the decision in a way that highlights that nontax purpose, but may not be willing to write further that tax benefits played no role in the decision to purchase the shelter. Many corporate officials are comfortable taking very aggressive tax positions, but very few are willing to lie outright in support of those positions. Most corporate officials realize that false records may be challenged in court, in which case they will be in the position of either admitting the falsity of those records or risking perjury.

V. CONCLUSION

The economic substance test is dizzyingly complex, as readers who have gotten this far will no doubt attest. This complexity arises from a number of interrelated factors. First, the test is best seen as a technique of statutory interpretation, which poses open-ended and unanswerable questions. Second, the test must be applied to a near-infinite variety of economic activities and transactions. Third, the present treatment of capital is inconsistent and to some extent incoherent. Taxpayers can exploit this incoherence by structuring transactions that produce tax benefits out of thin air. And conflicting rules make it difficult, sometimes, to determine the "correct" treatment of a particular transaction. Finally, only a few cases have been decided under the economic substance test, leaving open multiple interpretations of the doctrine.

It is virtually certain that more cases will be decided under the test, and that courts will fill in some of the lacunae and resolve some of the ambiguities. The other sources of complexity will remain. In the end, the utility of the doctrine will depend upon the nature of shelter activity. As discussed throughout this paper, shelters that combine tax benefits with any real economic investment have historically been hard to sell. In the past, at least, "conservative" shelters, structured to include real investment, have generally been "cleansed" of that investment, and its corresponding risk, before finding corporate purchasers. The shelters decided in existing cases show no net investment and expected and realized negative rates of return, once transaction costs are taken into account. As long as the next generation of shelters is similarly barren of real investment, the economic substance test will work well. The test—or a similar method of statutory interpretation—may be necessary to prevent significant erosion of the corporate tax, and the tax now paid by individuals with substantial income from capital.[42] Should purchasers of shelters change their position and accept tax products that combine current-style shelters with significant economic investment, the economic test will break down. At that point, Congress may have no choice but to engage in substantive law reform. Some shelter activity will take place under even the most utopian tax

[42] This sanguine view assumes that the test will be intelligently applied by tax administrators—for example, that it will not be applied to tax-motivated transactions clearly supported by legislative intent, and so forth.

structure. However, the current tax treatment of capital needlessly multiplies shelter opportunities and provides a fertile breeding ground for shelter development.