STATE ECONOMIC SUBSTANCE DOCTRINE:
The Role of the Economic Substance Doctrine In State Business Tax Compliance

MTC Uniformity Committee

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An uncommonly used common law doctrine

States have many tools to combat domestic income shifting and base erosion, but sometimes application of the economic substance doctrine may be the best or only tool for the job.

Yet, use of the doctrine in state tax cases is fairly rare.

Only three state highest courts have recognized the doctrine's application in state income tax cases; one has rejected it.

Only one state has a statute specifically addressed to sham transactions/lack of economic substance;

Economic substance concepts play a role in many state "add-back" statutes; but many transactions and arrangements fall outside the scope of those statutes;

Economic substance also plays a role in transfer pricing disputes—if the transaction would not have been occurred between unrelated parties, it is unnecessary to determine an arms-length price for a related party transaction;

Administrative recognition of the doctrine may deter purely tax-motivated behavior and provide guidance to taxpayers, taxing agencies and courts in its application.

The common-law federal economic substance doctrine

The federal economic substance doctrine was first recognized by the U.S. Supreme Court in *Gregory v. Helvering*, 293 U.S. 465 (1935).

There has not been a universally agreed-upon meaning to the doctrine or application; one might describe the doctrine as permitting the taxing authorities to disregard the tax consequences of an arrangement, transaction or series of transactions that, while nominally meeting the tax code, fail to reflect actual economic activity and would create unintended tax consequences.

The federal courts have since identified several sub-classifications of the common law "anti-abuse doctrine" that we refer to here collectively as the economic substance requirement.

These sub-classifications have had limited application so far in the state context; we describe them in detail in the Addendum to this presentation:

Economic Substance

Substance Over Form

Sham Transaction Doctrine

Step Transaction Doctrine

The Evolving Federal Economic Substance Doctrine

By the 1990's, the federal application of the economic substance doctrine was a muddled field of conflicting doctrines, sub-doctrines and theories.

Some courts held that a transaction with actual economic effects (apart from taxation) should be upheld even if undertaken solely for tax savings purposes.

Other courts held a legitimate non-tax business purpose was always required. Some court held both business purposes and economic effects were required.

Still other courts employed a "totality of the circumstances" approach.

Even the burden of proof was unclear.

The "Unitary" or "Totality Of The Circumstances" Approach:

Business purpose and economic substance may be viewed as "simply more precise factors to consider in the application of [a] traditional sham analysis; that is, whether the transaction had any practical economic effects other than the creation of income tax losses." *Sochin v. C.I.R.*, 843 F.2d 351, 354 (9th. Cir. 1988).

State courts avoid split among federal courts, favoring “totality of circumstances” analysis

***Baisch v. Oregon DOR*, 850 P.2d 1109 (Or. 1993).**

Court has no hesitation in recognizing applicability of federal tax doctrine where Oregon tax base starts with federal tax, and where there was no state-specific adjustment.

The court recognizes split in federal authority but holds that real estate transaction front-loading interest expense without corresponding economic risk (since property would be sold before end of lease period) would not meet any federal standard.

Refuses to allow a partial deduction where entire transaction was a sham.

Application of economic substance principles to state-specific transactions

Transfers of Intangible Property to Intangible Holding Companies

***Syms Corp. v. Comm'r of Revenue*, 765 N.E.2d 758 (Mass. 2002):** trademarks transferred to thinly-incorporated Delaware holding company with no permanent employees. Tax motivated transaction. Royalties were repaid as a dividend in circular flow of money. No attempt to license intangibles to third parties.

Additional State Application in the Intangible Holding Company Context

Sherwin-Williams Co. v. Comm'r of Revenue, 778 N.E.2d 504 (Mass. 2002). State Supreme Judicial Court reaches the opposite result, distinguishing *Syms,* because holding company performed actual licensing functions and did license trademarks to third parties. Applied the federal "unitary analysis" test. But one could argue the similarities between the two arrangements outweighed the differences, and the income shifting effect was the same.

The "tax ownership" approach to intangible property transfers

Pacificare Health Systems v. Dept. of Revenue, 19 OTR 460, Ore. Tax Ct. No. 4762
https://cdm17027.contentdm.oclc.org/digital/collection/p17027coll6/id/172/rec/1

In this seminal decision, the tax court raised the issue of whether a transfer of ownership of the intangible property should be respected where (1) the transferor retained the right to reacquire the property rights where any number of easily controlled events occurred; (2) the transferor retained the economic benefits of the transferred property with no independent risk taking or profit seeking by the subsidiary; (3) the transfer did not accomplish its supposed business purpose of allowing additional the insurance company to write additional insurance. Because the transferor retained the "tax ownership" of the trademark, there was no need to address IRC 482 transfer pricing analysis.

Critical state distinction emerges: third party licensing activity by IHC

Hormel Foods Corp. v. Wisconsin Dept. of Revenue, Wisconsin Tax Appeals Comm. No. 07-11-17. https://www.wisbar.org/forPublic/INeedInformation/Tax%20Appeals%20Commission/2010/07-i-17.pdf

Relying on three Massachusetts' decisions, the Commission ruled that the transfer of intellectual property had no substantial business purpose (the proffered purposes were described as "mere fig leaves") and did not change the economic position of the taxpayer. The critical issue for the Commission was that the taxpayer did not engage in outside licensing activity. Also noted, an outside accounting firm had initiated and supervised the transactions.

Lack of economic substance may affect nexus determinations and apportionment in IHC context

Maryland has had a series of appellate court decisions applying the economic substance doctrine to find that intangible holding companies' separate existence should be disregarded for nexus and apportionment purposes. The courts have considered lack of business purpose for the transfers of intangible property, lack of outside licensing activity, circular flows of money, lack of independent employees, and evidence of tax motivation. ***Comptroller of the Treasury v. Syl, Inc. and Crown Cork & Seal, Inc,*** 825 A.2d 399 (Md. Ct. App. 2003); ***Staples, Inc. v. Comptroller of the Treasury,*** No. 2597, 2018 BL 287390 (Md. Ct. Spec. App. Aug. 09, 2018), Court Opinion.

Lack of economic risk or rewards supports finding loan participation transactions lacked economic substance:

T.D. Banknorth, N.A. v. Dept. of Taxes, 967 A.2d 1148 (Vt. 2008). The Vermont Supreme Court recognizes the economic substance doctrine, holding that a transfer of bank deposits to an out of state entity through a loan participation agreement with itself did not share risk or have any non-tax business purpose. The taxpayer agreed that taxes were the sole motivation for the arrangement.

Massachusetts takes a leading role in application of economic substance doctrine

Massachusetts has been particularly active in challenging the economic substance of transactions, especially in the context of intercompany loans and embedded royalty arrangements. Some of its most significant litigation includes:

***Sysco Corp. v. Comm'r of Revenue*, 83 Mass. App. Ct. 1127, 986 N.E.2d 895 (App. Ct. 2013);**

***Kimberly-Clark Corp. v. Comm'r of Revenue*, 83 Mass. App. Ct. 65, 981 N.E.2d 208 (App. Ct. 2013),**

***Allied Domecq Spirits & Wines USA, Inc. v. Comm'r of Revenue*, 85 Mass. App. Ct. 1125, 10 N.E.3d 178 (App. Ct. 2014).** In this case, the taxpayer transferred property and employment contracts of a subsidiary in Massachusetts to the taxpayer's own books, with the intent to create a substantial nexus within the state, which in turn would allow the taxpayer to join the Massachusetts' combined return, offsetting the profits of the combined return's members with its losses. The state used economic substance principles to argue that a purely tax-motivated transfer should not be respected and disallowed the losses claimed against the combined return.

The Minnesota Supreme Court demurs

In ***HMN Fin., Inc. v. Comm'r of Revenue*, 782 N.W.2d 558 (Minn. 2010)**, the Minnesota Supreme Court held that the state tax commissioner lacked statutory and common law authority to disregard the tax effects of a series of transactions involving a captive REIT, a foreign operating company with a single employee in the Cayman Islands, and a circular flow of funds.

The court recognized that state tax savings were the sole motivation for the arrangement, but nonetheless rejected application of the common law principle of "substance over form." It is unclear whether the court considered other variants of the economic substance doctrine.

HMN Financial has not been followed by any court outside of the state of Minnesota, but it likely has had a chilling effect on state tax agencies looking to pursue economic substance arguments.

Newer tax planning may require states to consider challenging economic substance

Paper or shell IHC's are out (so they say).

IP income is now booked in more substantive entities operating in limited numbers of taxing jurisdictions;

Business activities are dis-aggregated into multiple separate corporations, nominally providing intercompany services.

Separate-entity states are particularly vulnerable base erosion caused by inflated "management fees," "procurement services", or disguised interest or intangible property expenses.

Transfer pricing adjustments can reduce tax losses from these arrangements, but the adjustment process is time-consuming, expensive, and often results in a compromise of tax liability.

A sharper focus on the economic substance of these arrangements may be an effective means of preventing inappropriate income shifting, if states are willing.

The federal codification of the economic substance doctrine should encourage state applications as well.

In 2010, as part of the Affordable Health Care Act, Congress codified the economic substance doctrine in the penalty provisions of the Code:

IRC 7701(o): Clarification of economic substance doctrine.

(1) Application of doctrine. In the case of any transaction to which the economic substance doctrine is relevant, such transaction shall be treated as having economic substance only if–

(A) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, *and*

(B) the taxpayer has a substantial purpose (apart from Federal [*or state*] income tax effects) for entering into such transaction.

*Note: burden of proof is on taxpayer; it must prove **both** economic effects and substantial non-tax business purpose.*

States would benefit from a similar codification of the economic substance doctrine, or alternatively, regulatory guidance

The federal "clarification" of the federal common law doctrine did not lead the way to similar state codifications.

States may feel that the federal codification will automatically apply in the state tax context.

The federal codification occurred in the federal penalty context. Most states do not automatically conform to federal penalty provisions or concepts.

The federal codification has not been cited in any state appellate decision to date.

Only one state appears to have codified the economic substance doctrine explicitly. And that state is…

YES, THAT STATE

Section 62C:3A. Disallowance Of Sham Transactions And Related Doctrines; Burden On Taxpayer To Show Business Purpose And Economic Substance Commensurate With Claimed Tax Benefit

In applying the laws referred to in section 2, the commissioner may, in his discretion, disallow the asserted tax consequences of a transaction by asserting the application of the sham transaction doctrine or any other related tax doctrine, in which case the taxpayer shall have the burden of demonstrating by clear and convincing evidence as determined by the commissioner that the transaction possessed both: (i) a valid, good-faith business purpose other than tax avoidance; and (ii) economic substance apart from the asserted tax benefit. In all such cases, the taxpayer shall also have the burden of demonstrating by clear and convincing evidence as determined by the commissioner that the asserted nontax business purpose is commensurate with the tax benefit claimed. Nothing in this section shall be construed to limit or negate the commissioner's authority to make tax adjustments as otherwise permitted by law.

Acts 2003 , c. 4 , § 10 , eff. 3/5/2003

Mass. Sec. 62c:3a: And Sec. 7701(o), Compared

Both statutes put burden of proof on taxpayer, but Massachusetts requires "clear and convincing evidence."

The federal statute defines economic substance: "changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position."

Massachusetts adds a third requirement: "that the asserted nontax business purpose is commensurate with the tax benefit claimed."

Economic Substance and the MTC's Reportable Transactions Model Statute

In 2004, Congress adopted a series of Code provisions requiring taxpayer to report certain "reportable transactions" in an effort to reduce tax shelter promotional activity. See IRC Sec. 6011, 6111, 6112, 6501, and others.

That same year the Uniformity Committee embarked on a similar effort to develop a model statute for state tax "reportable transactions" that were deemed likely to create the opportunity for domestic income shifting. The model as approved by the Commission in 2006 referenced economic substance concepts but left the definition of economic substance and the delineation of listed reportable transactions to the states wishing to adopt the model.

Although some seven states already had some reportable transactions requirements, it does not appear that any additional states adopted the model. The hearing officer's report on the model and its development is here: http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Projects/A_-_Z/RT%20%20IFP%20HO%20Report-%20Final.pdf.

Addendum: More on the Federal Common Law Anti-Abuse Doctrines

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Anti-Abuse Doctrines

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The pre-codification judicial landscape

Gregory v. Helvering, 293 U.S. 465 (1935).

- In *Gregory*, a wholly owned corporation transferred 1000 shares of stock of another corporation to a new corporation, which thereupon issued all of its shares to the taxpayer.
- A few days later, the new corporation distributed the 1000 shares to the taxpayer, who immediately sold them for her individual profit.
- The transaction was designed to conform to the requirements of § 112 of the Revenue Act of 1928 as a "reorganization".
- Judge Learned Hand, writing for the Second Circuit Court of Appeals found that, "[a]nyone may so arrange his affairs that his taxes shall be as low as possible" but "[t]o dodge the shareholders' taxes is not one of the transactions contemplated as corporate 'reorganizations.'"

Frank Lyon Co. v. United States, 435 U.S. 561 (1978).

- The taxpayer borrowed $7.1M, bought a building from a bank for $7.6M, and leased the building back to the bank.
- Taxpayer received payments equal to the taxpayer's payments of principal and interest on the $7.1M, along with a fixed rate of return on its $500,000 investment.
- The Supreme Court held that the transaction was valid.

"

Where … there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached, the Government should honor the allocation.

"

Frank Lyon Co. v. United States, 435 U.S. 561 (1978).

After *Frank Lyon, it was clear that economic substance consisted of both an objective, economic substance test, and a subjective, business purpose test.*

Economic Substance: Two-Prong Test

Has the taxpayer shown that the transaction materially altered the taxpayer's economic position?

Has the taxpayer shown that there was a business purpose for entering into the transaction, other than tax avoidance?

How does it apply?

Conjunctive Test

- The transaction must have economic effects aside from tax benefits *and* a non-tax business purpose.
- First, Seventh, Eleventh, and Federal Circuits

Disjunctive Test

- The transaction must have economic effects aside from tax benefits *or* a non-tax business purpose.
- Second, Eighth, and D.C. Circuits

Unitary Analysis

- Other Circuits have held that the objective and subjective prongs are 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." *ACM P'ship v. Commissioner, 157 F.3d 231 (3d Cir. 1998).*
  - Third, Sixth, Ninth, and Tenth

Codification of the Economic Substance Doctrine

The economic substance doctrine was codified in IRC § 7701(o) as part of the Health Care and Education Reconciliation Act of 2010.

- (o) Clarification of economic substance doctrine
  - (1) *Application of doctrine*. In the case of any transaction to which the economic substance doctrine is relevant, such transaction shall be treated as having economic substance only if—
    - (A) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and
    - (B) the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction.

So for cases after codification, the conjunctive test will apply in all Circuits.

Substance Over Form

Substance Over Form

- Broadest of the anti-abuse doctrines
- Originated in *Gregory v. Helvering*
  - "As a general rule, the incident of taxation depends on the substance rather than form of the transaction."
- Generally raised when the taxpayer chooses a form that is inconsistent with the substance of the transaction *and* provides the taxpayer with a benefit that would not be available if the form was consistent with the substance.
- Often raised in response to leasing transactions, related party transactions, and in debt/equity determinations.

Sham Transaction Doctrine

Two types of sham transactions

- Sham in substance
  - Economic sham
  - Similar to the two-prong economic substance test
  - "[T]he expedient of drawing up papers to characterize transactions contrary to objective economic realities which have no economic significance beyond expected tax benefits. *Falsetti v. Commissioner*, 85 T.C. 332, 347 (1985).
- Sham In fact
  - Factual sham
  - Occurs when the transaction in question did not occur or was substantially different than reported.

Step Transaction Doctrine

Step Transaction Doctrine

- “[I]nterrelated yet formally distinct steps in an integrated transaction may not be considered independently of the overall transaction. By thus "linking together all interdependent steps with legal or business significance, rather than taking them in isolation," federal tax liability may be based "on a realistic view of the entire transaction." Commissioner v. Clark, 489 U.S. 726 (1989).

Step Transaction Doctrine

- Courts have articulated three tests to determine whether the step transaction doctrine is applicable:
  - 1. The “binding commitment” test
  - 2. The “end result” test
  - 3. The “mutual interdependence” test

Binding Commitment

Under the binding commitment test, separate steps in a transaction will be collapsed into a single transaction if, at the time the first step takes place, the taxpayer was under a binding commitment to complete the remaining steps.

"The purpose of the binding commitment test is to promote certainty in tax planning; it is the most rigorous limitation of the step transaction doctrine. It is seldom used and is applicable only where a substantial period of time has passed between the steps that are subject to scrutiny." Andantech, LLC v. Commissioner, 83 T.C.M. (CCH) 1476, T.C. Memo. 2002-97.

End Result Test

- "The 'end result' test amalgamates into a single transaction separate events which appear to be component parts of something undertaken to reach a particular result," *King Enters., Inc. v. United States, 418 F.2d 511 (Ct. Cl. 1969).*

Mutual-Interdependence Test

Under the mutual interdependence test, the step transaction doctrine applies if "the steps are so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series." Redding v. Commissioner, 80-2 USTC Para. 9637, 630 F.2d 1169 (7th Cir. 1980).

If the steps have "reasoned economic justification standing alone", then the interdependence test is inappropriate. *Sec. Indus. Ins. Co. v. United States, 702 F.2d 1234 (5th Cir. 1983).*

Which test applies?

- Some courts have found that more than one test must be met in order for steps to be collapsed under the step transaction doctrine.
- In some cases, a lapse of time between steps can indicate whether steps should be collapsed.
- A lapse of time can also indicate which test should be used.
  - E.g., a significant lapse between steps where the taxpayer has a binding commitment to complete the remaining steps could still be collapsed under the binding commitment test.