

# The Economic Substance Doctrine in State Tax Practice

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Effective for transactions entered into after March 30, Congress added section 7701(o) to the Internal Revenue Code and also added new 20 percent and 40 percent penalties on underpayments because of violation of the economic substance doctrine (ESD) or “similar rules of law.” The effect of this change in federal income tax law on state tax practice is likely to be an acceleration of a trend already seen in the application of the ESD and related doctrines (for example, sham transaction, step transaction) to state taxpayers. This article examines the range of possible effects and offers defenses and arguments that taxpayers can use to minimize the damage.

## Overview of Federal Codification of the ESD<sup>1</sup>

The Health Care and Education Reconciliation Act of 2010, H.R. 4872, section 1409,<sup>2</sup> claims to codify, or at least clarify, the ESD. It does so by adopting section 7701(o) to define the standard taxpayers must meet to avoid application of the

ESD, if the doctrine is “relevant” to the tax benefits the taxpayer claims, and by imposing no-fault penalties of 20 or 40 percent, applicable to transactions after March 30, 2010.

The heart of the provision is this definition in section 7701(o)(5)(A):

The term “economic substance doctrine” means the common law doctrine under which tax benefits under subtitle A with respect to a transaction are not allowable if the transaction does not have economic substance or lacks a business purpose.

The operative rule of section 7701(o)(1) states that if the ESD is “relevant” to a transaction, the transaction shall be treated as “having economic substance” only if it changes the taxpayer’s economic position in a meaningful way *and* the taxpayer has a substantial purpose for entering into the transaction apart from federal income tax effects.

The signal features of section 7701(o), adopted in 2010, are:

- it confirms the existence of a judicially created positive rule of law that can deny the allowance of income tax benefits to which taxpayers are otherwise entitled; and
- it defines the necessary (but not necessarily sufficient) proof taxpayers must make to avoid denial of any subtitle A tax benefits resulting from a transaction to which the Service applies the ESD, without imposing any statutory limit on when the government can apply the ESD.

Statements in the Joint Committee on Taxation’s description of the 2010 budget proposals<sup>3</sup> and other legislative history add color to the description of the ESD:

<sup>1</sup>This portion of the article draws from a new book by Jasper L. Cummings Jr. of Alston & Bird’s Raleigh, N.C., office: *The Supreme Court’s Federal Tax Jurisprudence* (American Bar Association Section of Taxation 2010).

<sup>2</sup>P.L. 111-152.

<sup>3</sup>Description of Revenue Provisions Contained in the President’s Fiscal Year 2010 Budget Proposal, Part II: Business Tax Provisions, 34-71, JCS-3-09 (Sept. 9, 2009) (Committee Print); see also Technical Explanation of the Revenue Provisions Contained in H.R. 3962, Joint Committee on Taxation, JCX-47-09, 80 *et seq.* (Nov. 5, 2009).

The Economic Substance Doctrine: A taxpayer whose facts (as properly determined by use of all applicable substance over form methods of fact finding) otherwise satisfy the legal requirements (as properly interpreted) for a tax benefit (whether the benefit is generally viewed as a benefit to taxpayers, or is beneficial to the particular taxpayer only because of the particular facts of the case), shall be denied that tax benefit if (1) the Service denies the tax benefits in whole or part by asserting application of the ESD to the taxpayer's transaction that facilitated the tax benefits, (2) the taxpayer was motivated to carry out that transaction by a purpose to obtain that tax benefit, (3) the benefit was not intended by Congress, and (4) the taxpayer fails to prove satisfaction of the two prong codified economic substance doctrine test.

Interestingly, although the statute includes a statement that the ESD should be applied as if the codification had never been enacted, aspects of the codification (for example, the statute's requirement that a challenged tax benefit have economic substance *and* a business purpose) suggest that the codification of the ESD is intended to have a broader effect by standardizing what had been inconsistent requirements from circuit to circuit in applying the doctrine. The extent to which the (now codified) ESD will be applied by state tax administrators is the subject of the remainder of this article.<sup>4</sup>

### The Direct Piggyback Effect

Before the codification of the ESD, many state income tax auditors were applying the ESD as it was already being applied by the federal courts to adjust federal taxable income — generally based on a state law provision (or in some cases, simply a state law theory) authorizing the application of the federal doctrines in state tax contexts.<sup>5</sup> For example, in upholding an assessment of North Carolina state income taxes, the secretary said:

Included in this authority to determine federal taxable income is the power to use equitable

doctrines developed at the federal level, such as the step transaction doctrine.<sup>6</sup>

The secretary added that it had previously held that “all federal statutes, doctrines, and case law relevant to determining federal taxable income are available for use by the state.”<sup>7</sup>

**The starting position for taxpayers in state cases should be that the economic substance doctrine is not relevant beyond the issues that can arise under the IRC.**

Thus, the codification of the ESD in federal law will likely have little impact on state tax decisions that turn directly on determinations of federal taxable income. State tax departments have been applying the ESD (and other equitable doctrines applied by the IRS and blessed by the federal courts) for years, in reliance on decisions by the U.S. Supreme Court and other federal authorities, and there is little reason to believe that states have held back from applying the doctrines to federal tax concepts simply because the ESD had not been memorialized in the U.S. Code.<sup>8</sup>

### Extension to State-Specific Income Tax Issues

Several important issues in state tax contexts simply do not have federal analogs. Most notably, those include allocation and apportionment issues for multistate taxpayers, including the subcategory of business versus nonbusiness income, and the U.S. Constitution's commerce clause nexus issues. The threshold issue at the state level is the relevance of the ESD to the state tax issue, because section 7701(o)(1) states that the ESD must be relevant to a transaction before the doctrine should be applied. Therefore, the starting position for taxpayers in state cases should be that the ESD is not relevant beyond the issues that can arise under the IRC.

<sup>4</sup>For a more in-depth exploration of states' application of the economic substance doctrine (ESD) and related doctrines, see Jeffrey C. Glickman and Clark R. Calhoun, “The ‘States’ of the Federal Common Law Tax Doctrines,” 61 *The Tax Lawyer* 1181 (2008).

<sup>5</sup>See, e.g., *Syms Corp. v. Comm'r*, 765 N.E.2d 758 (Mass. 2002), and *Sherwin-Williams Co. v. Comm'r*, 778 N.E.2d 504 (Mass. 2002) (applying Mass. Gen. Laws ch. 62C, section 3A (2003) (granting authority to the Massachusetts commissioner to disallow asserted tax consequences of a transaction “by asserting . . . the sham transaction doctrine or any other related tax doctrine”). For the decision in *Syms*, see *Doc 2002-8734* or *2002 STT 71-23*; for the decision in *Sherwin-Williams*, see *Doc 2002-24629* or *2002 STT 213-20*.

<sup>6</sup>*In re Proposed Assessment of Corp. Income Tax for Tax Years Ended Dec. 31, 1989 and 1990 by the Sec'y of Revenue of N.C.*, No. 95-144, 1997 N.C. Tax LEXIS 48 (N.C. Dep't of Revenue Aug. 26, 1997).

<sup>7</sup>*Id.* at \*34.

<sup>8</sup>See, e.g., *Syms*, 765 N.E.2d at 762 n.7 (citing federal cases applying the economic substance doctrine); *McMillin-BCED/Miramar Ranch North v. County of San Diego*, 37 Cal.Rptr.2d 472 (Cal. App. 4th Dist. 1995) (citing federal cases applying the step transaction doctrine); *SLI International Corp. v. Crystal*, No. CV93 0519789S, 1994 WL 450466 (Conn. Super. Ct. Aug. 12, 1994), *rev'd on other grounds*, 671 A.2d 813 (Conn. 1996); *Baisch v. Dep't of Revenue*, 850 P.2d 1109 (Ore. 1993).

However, state revenue departments have asserted and likely will continue to assert the opposite. Indeed, although at least one state has refused to extend the ESD to a state income tax issue with no federal analog,<sup>9</sup> several states have not hesitated to apply the ESD and related doctrines to state tax issues, with or without a comparable federal income tax concept. For example, the Idaho State Tax Commission upheld the application of the step transaction doctrine to an adjustment of a taxpayer's apportionment factors.<sup>10</sup> Thus, that an income tax issue has no comparable federal concept appears unlikely to prevent a state from asserting that the ESD is relevant to the determination of that income tax item.

### Extension to Tax Issues Other Than Income Taxes

The codified ESD applies only to the federal *income* tax and has an exception for "personal transactions of individuals" not connected to any trade or business.<sup>11</sup> Therefore, the ESD codification does not apply at the federal level, for example, to the estate and gift taxes, nor does it apply to employment or excise taxes.

State governments, of course, rely on an even wider array of non-income-based taxes than the federal government. Examples include property taxes, license taxes, sales and use taxes, and real estate transfer taxes. Given that the codified ESD applies only to income taxes, the codification of the ESD arguably should have no relevance to a state's non-income-based taxes; moreover, the federal limitation on the application of the codified ESD to income taxes gives taxpayers an argument that states should not be able to apply the doctrine outside the income tax context.

However, it would be foolish to assume that states could not take a more aggressive position in apply-

ing the ESD outside the income tax context. Although states have historically been much less likely to apply the doctrines to other taxes, there are precedents for states doing so. For example, in *In re TJX Cos.*, TJX Companies Inc. contracted with Ames Department Stores Inc. to sell to Ames a division of TJX referred to as the Zayre Division.<sup>12</sup> The parties agreed to structure that transaction for federal income tax purposes so that each of them could make an IRC section 338(h)(10) election. To effectuate that structure, TJX made capital contributions of Zayre assets to four wholly owned subsidiaries, then transferred the stock in those subsidiaries to Ames for cash. In accordance with the section 338(h)(10) election, the subsidiaries were treated as if they had sold all of their assets as of the date of the transaction.<sup>13</sup>

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Following that transaction, the New York Division of Taxation assessed the taxpayer for unpaid *sales* tax, arguing that under the ESD the transactions should be treated in substance as a single transaction giving rise to a taxable sale of assets. The New York Division of Tax Appeals rejected that position, stating that the structure of the transaction was designed to take advantage of a specific federal tax provision and therefore had a valid non-sales-tax-avoidance purpose.<sup>14</sup> Thus, although the New York administrative law judge rejected the state's attempt to apply the ESD in that sales tax context, the case shows that state departments of revenue have been willing to apply the ESD and other doctrines outside the income tax arena. Cases from Illinois, New York, and Tennessee demonstrate

<sup>9</sup>*Dep't of Revenue v. Puffnstuff, Inc.*, No. IT 01-18 (Ill. Dep't of Revenue Office of Admin. Hearings, Oct. 5, 2001), available at <http://www.revenue.state.il.us/legalinformation/hearings/it/it01-18.pdf> (state administrative judge refused to allow application of step transaction doctrine to force recognition of nonbusiness income because state should apply a federal doctrine only in a "comparable context" to the way the doctrine is applied at the federal level). Note that "Puffnstuff," as well as other names in the decision, are aliases.

<sup>10</sup>*In re Petitioner*, No. 15696, 2002 WL 34135092 (Idaho State Tax Comm'n Sept. 16, 2002); see also *TD Banknorth, N.A. v. Dep't of Taxes*, 967 A.2d 1148 (Vt. Sept. 19, 2008) (upholding application of ESD regarding the state's bank franchise tax); *Wal-Mart Stores East, Inc. v. Hinton, Sec'y of Revenue*, No. 06-CVS-3928, slip. op. at 23 (N.C. Super. Ct. Dec. 31, 2007) (applying the ESD to a captive real estate investment trust structure and allowing the secretary to require combined returns). For the decision in *Banknorth*, see *Doc 2008-20199* or *2008 STT 185-22*.

<sup>11</sup>26 U.S.C. section 7701(o)(5)(B).

<sup>12</sup>No. 812048, 1995 N.Y. Tax LEXIS 590 (N.Y. Div. of Tax App. Nov. 9, 1995), *aff'd on other grounds*, No. 812048 (N.Y. Tax App. Trib. Feb. 13, 1997).

<sup>13</sup>*Id.* at \*16-17.

<sup>14</sup>*Id.* at \*22. After considering the state's argument regarding the ESD, the administrative law judge considered the state's additional argument that the step transaction doctrine should be applied. The ALJ concluded that the step transaction analysis was not appropriate to determine whether sales tax should be due. *Id.* at \*27. However — as is clear from *Kelly I*, cited *infra* at note 15 — the state's conclusion in *TJX* should not be taken as a rejection of the step transaction doctrine in all non-income-tax contexts under New York law.

states' willingness to apply the federal tax doctrines in a variety of non-income-tax contexts.<sup>15</sup>

Therefore, based on these examples, it is apparent that states have been — and will continue to be — willing to apply the ESD and other tax doctrines to frustrate the anticipated state tax consequences of a transaction. Further, as discussed above, the codification of the ESD could embolden state tax departments to apply the ESD and other doctrines much more broadly than they have in the past.

### The Proper Role of the ESD

As indicated above, the ESD is most properly viewed as a positive rule of law that decrees that the taxpayer loses even though it otherwise is entitled to the tax benefit, if the taxpayer cannot carry the burden of proof on the two prongs of the codified ESD test. Unfortunately, many federal courts have begun to skip directly to the ESD issue, overlooking taxpayers' arguments that the ESD is not relevant to the circumstances or that the tax benefit was intended on the taxpayer's facts. State courts can be expected to take the same shortcuts. Taxpayers, particularly those that are relatively comfortable with their facts and the law, should protest that the ESD is designed to be a last step (and rarely applied) because it upsets the law as written by the legislature.

### Statutory Interpretation

*Gregory v. Helvering*<sup>16</sup> is said to be “all things to all men,”<sup>17</sup> and “one of the most protean judicial doctrines in the tax law.”<sup>18</sup> The U.S. Treasury identifies it as the origin of both the substance-over-form doctrine and the business purpose doctrine,<sup>19</sup> and hence the core of the tax-specific doctrines. But in reality, *Gregory* was a case of statutory construction

in which the U.S. Supreme Court construed a normal course-of-business requirement into the statutory words “in pursuance of a plan of reorganization.” *Gregory* did not create an all-purpose requirement for “business purpose” for enjoyment of all allowances and deductions, much less all tax “benefits” (as asserted in the ESD).<sup>20</sup> No Supreme Court decision says it did, although later Court opinions recognized that the transitory corporation *Gregory*'s plan used would be ignored for tax purposes (and called a sham) because it had no business or corporate purpose, under the later announced rule of *Moline Properties*.<sup>21</sup>

Therefore, when the codification of the ESD memorializes the requirement of a substantial non-tax-avoidance purpose to qualify for a tax benefit, it presumably is reaching back to authority like *Gregory*, which did something very different: It interpreted a requirement of a business purpose into a specific code section based on some real evidence of the plain language of the statute (there, the Court understood that reorganization commonly meant an actual realignment of a real business, and required such a realignment to obtain the tax benefit).

**States that have been less aggressive in applying the doctrines to state tax issues may begin to assert the doctrines on a more regular basis.**

This reflection on *Gregory* is a long way of noting that while it may often be contrary to a taxpayer's interest to direct a court to consider the legislative intent behind a particular tax provision, in some cases the best strategy to avoid the application of the ESD will be to focus the court or administrator's attention on the meaning of the taxing statute. If the court or administrator believes that the tax benefit was intended (or at least that the claimed benefit is

<sup>15</sup>See also *JI Aviation, Inc. v. Ill. Dep't of Revenue*, 781 N.E.2d 469 (Ill. App. Ct. 2002) (applying substance-over-form and step transaction doctrines to purchase of aircraft involving qualified intermediary); *Hutton v. Johnson*, 956 S.W.2d 484 (Tenn. 1997) (adopting step transaction doctrine to determine whether purchaser of aircraft was entitled to trade-in credit); *In re Kelly I*, No. 819863, 2005 N.Y. Tax LEXIS 282 (N.Y. Div. of Tax. App. Dec. 8, 2005) (applying step transaction doctrine to real estate transfer taxes). *But see Estep v. King County*, 401 P.2d 332, 334 (Wash. 1965) (rejecting application of step transaction doctrine to transaction involving real estate excise tax, stating that “adoption of the rule would write into Washington law a provision not voiced by the legislature”).

<sup>16</sup>*Gregory v. Helvering*, 293 U.S. 465 (1935).

<sup>17</sup>Randolph E. Paul, *Studies in Federal Taxation*, Third Series, at 126 (Harvard 1940).

<sup>18</sup>Robert Clark, “The Morphogenesis of Subchapter C: An Essay in Statutory Evolution and Review,” 87 *Yale L.J.* 90, 122 (1977).

<sup>19</sup>Treasury White Paper on Corporate Tax Shelters IVB1 and 2 (July 1, 1999), 1999 *TNT* 127-12 (July 1, 1999).

<sup>20</sup>Robert S. Summers, “A Critique of the Business Purpose Doctrine,” 41 *Ore. L. Rev.* 38, 40 (1961) (identifying as one of the least accurate formulations of the doctrine the statement that “to reduce taxes, a taxpayer must always show that he intended his transactions to serve a non tax purpose”).

<sup>21</sup>*Moline Properties, Inc. v. Commissioner*, 319 U.S. 436 (1943). See Miller, “Federal Courts as Makers of Income Tax Law,” 6 *Tax L. Rev.* 151, 161 (1951) (citing *Gregory* as a chief example of lower courts turning what should have been a dummy corporation decision into a new principle of law). The Court made this connection of *Moline* to *Gregory* in *Nelson v. Adams, USA, Inc.*, 529 U.S. 460, 471 (2000), and *National Carbide Corp. v. Commissioner*, 336 U.S. 422 (1949). But even in 1935 the Court called *Gregory* a sham transaction case. *Helvering v. Minnesota Tea Co.*, 296 U.S. 378, 385 (1935).

not abusive), the ESD may be deemed not relevant and the taxpayer will not be required to satisfy its two prongs.

### Conclusion

Thus, to a large degree, it appears that the codification of the ESD at the federal level will not have much of an effect on the behavior of state tax administrators, because state tax administrators have already been applying the ESD and related doctrines in state tax contexts — both those involving income tax issues as well as (though less frequently) other types of taxes. However, that the federal statute applies the ESD only to income taxes gives taxpayers some ammunition that states' application of the doctrine should be also limited to income tax issues. It is questionable whether that

argument will succeed. What is clear is that the codification of the ESD at the federal level is likely to further embolden those states already applying the doctrine. It is also likely that those states that have been less aggressive in applying the doctrines to state tax issues will reexamine their practices and may begin to assert the doctrines on a more regular basis. ☆

*Audit + Beyond, a column on state tax audits and the resolution of disagreements between business taxpayers and state revenue departments, is written by members of the Alston & Bird LLP state and local tax group. Jeffrey C. Glickman is a partner and Clark R. Calhoun is an associate with the firm's Atlanta office.*