

Business Purpose, Economic Substance Don't Apply to Intended Tax Benefits

by Arthur R. Rosen

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Background

Every tax professional knows that “nobody owes any public duty to pay more [taxes] than the law demands.”¹ Even the most ardent and aggressive government tax officials do not deny the validity of that principle. There is, however, abundant controversy regarding what the term “the law” means in that context. Does it mean the statute as enacted by a duly elected legislature or does it mean what is “just” or “fair” in the eyes of an executive branch administrative agency or a court, through the use of common law doctrines such as business purpose and economic substance?

This controversy can be seen as a debate about which of two societal models should prevail, the rule of law or the rule of man. As a child growing up in various places in our country, I was consistently taught that one of the fundamental characteristics that made America great was our following the rule of law; in other words, no individual could, using the mantle of government, dictate what rules would govern our lives. When an administrative agency or a court declines to follow a statute as written, and instead applies common-law tax doctrines such as business purpose and economic substance, we have departed from the rule of law. (Case law, in the area of code law like taxation, is intended merely to interpret statutes — not add to statutory requirements.)

Some who defend the use of the business purpose and economic substance doctrines argue that strictly following the words in a statute can lead to tax results that “obviously” were unintended by the legislative body that enacted the statute. That, however, is a small price to pay for having a government

that follows the law as written; the legislature can surely fix the law, if it is being used in an unintended fashion, so government revenue in the future will reflect true legislative intent.

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All that having been said (preached?), I concede that I must accept reality and acknowledge that since the U.S. Supreme Court’s decision in *Gregory v. Helvering*² in 1935, common-law tax doctrines that attempt to graft presumed legislative intent onto statutes is part of our accepted jurisprudence. There is, however, at least one area — intended tax benefits (ITBs) — in which doctrines such as business purpose may not be able to intrude.

Intended Tax Benefit Situations

Congress and state legislatures regularly enact statutes that are clearly intended to provide specific tax benefits, such as real estate investment trusts, captive insurance companies, and some state-specific tax classifications. Mere executive branch administrative agencies (that is, state revenue departments) should not be able unilaterally to deprive taxpayers of those benefits. Fortunately, many courts agree.

The most recent example of a court preventing a state revenue department from depriving a taxpayer of an ITB is the decision of the Minnesota Supreme Court in *HMN Financial, Inc. and Affiliates v.*

¹*Gregory v. Helvering*, 293 U.S. 465 (1935).

²[293 U.S. 465 (1935)].

Commissioner of Revenue.³ In *HMN* the taxpayer established a “captive” REIT, carefully following the relevant federal and Minnesota statutes. Evidently, the establishment and operation of the REIT had no economic effect, other than substantial state tax savings, on the ultimate owners of the taxpayer. The Minnesota Department of Revenue, in addition to making some factual assertions that the Minnesota Supreme Court summarily dismissed, argued (successfully in the tax court) that the taxpayer had no nontax business purpose in establishing or operating the REIT and that there was no economic substance to the arrangement. Therefore, the department argued, the tax benefits from the use of a REIT (the REIT’s dividends paid deduction, the shareholder of the REIT’s classification as a Minnesota foreign operating corporation, and the taxpayer’s 80 percent dividends received deduction) should be disallowed. The court first addressed each statutory provision that arguably gave the commissioner discretionary authority, and concluded that none of those provisions give the commissioner the authority to disregard completely the results of a statutorily created situation. Most significantly, the court concluded:

If Minnesota statutes allow a favorable tax treatment, neither our court nor the Commissioner has the power to disregard those statutes and impose a different tax treatment When a business complies with all of the relevant tax statutes, that business is subject to tax in accordance with these statutes.⁴

In other words, the law is the law, even if some may believe it unfair.

Federal courts, in a similar manner, have consistently ruled that companies cannot be denied tax benefits flowing from special entities that were specifically designed to provide various advantages to businesses and to encourage targeted economic development. For example, the tax benefits flowing from Western Hemisphere trade corporations, which were designed by Congress to encourage exportation of goods and services from the United States, have repeatedly been upheld against IRS challenge.⁵ As stated by the Tax Court:

When the Congress offered certain tax benefits as an inducement to United States corporations to engage in foreign trade, it was to be expected that some corporations would seek to avail themselves of these benefits. The creation of a subsidiary to carry on the business in the Western Hemisphere area . . . does not constitute tax avoidance . . . and there seems to be no good reason why the deliberate organizing of such a corporation’s business and sales procedures to meet the other conditions specified by the legislation and thereby to qualify for the tax benefits offered should be regarded as tax avoidance. Otherwise the purpose of organizing the subsidiary would be lost and the congressional objective would not be carried out.⁶

Similarly, the IRS ruled that a limited partnership organized to take advantage of tax benefits conferred by the National Housing Act on the purchase of low-income housing could claim those tax benefits because denial of the benefits “would frustrate congressional intent in enacting the housing legislation.”⁷

Common-law tax doctrines are clearly improper in the context of intended tax benefits.

Returning to the state level, it is noteworthy that Minnesota is not the only state with courts that have recognized that absolute deference should be afforded to legislatures. For example, in *SLI International Corp. v. Crystal*, the Connecticut Supreme Court ruled that a corporation could deduct commissions paid to its foreign sales corporation, “because FSCs in general, and this one in particular, [has] economic substance. . . . [Also,] the parties have stipulated that [the FSC] is a valid FSC, properly created under federal law, and therefore necessarily had expenses and other potential sources of income.”⁸

Addressing the same FSC issue, the Wisconsin Tax Appeals Commission concluded that “by definition under federal FSC law,” the FSC in question had economic substance because it complied with the federal FSC requirements, and that accordingly the tax deductions paid to the FSC could not be denied.⁹

³Minnesota Supreme Court Docket No. A09-1164 (May 20, 2010).

⁴But see *TD Banknorth, N.A., v. Dep’t of Taxes*, 2008 Vt. 120 (2008).

⁵See, e.g., *Comm’r of Internal Rev. v. Pfaudler Inter-American Corp.*, 330 F.2d 471 (2nd Cir. 1964); *Comm’r of Internal Revenue v. Hammond Organ Western Export Corp.*, 327 F.2d 964 (7th Cir. 1964); *Frank v. International Canadian Corp.*, 308 F.2d 520 (9th Cir. 1962); *A.P. Green Export Co. v. United States*, 151 Ct. Cl. 628 (Ct. Claims 1960); *Pan American Eutectic Welding Alloys Co. v. Comm’r of Internal Revenue*, 36 T.C. 284 (U.S. Tax Court 1961).

⁶*Barber-Greene Americas, Inc. v. Comm’r of Internal Revenue*, 35 T.C. 365, 386 (U.S. Tax Court 1960).

⁷Rev. Rul. 79-300; 1979-2 C.B. 112.

⁸*SLI International Corp. v. Crystal*, 236 Conn. 156, 175 (Conn. 1996). (For the decision, see *Doc 96-6046* or *96 STN 44-2*.)

⁹*Kimberly-Clark Corp. v. Wisconsin Dep’t of Rev.*, 1994 Wis. Tax LEXIS 13 (Wis. Tax App. Comm. 1994). (For the decision, see *94 STN 92-23*.)

The New York State Tax Appeals Tribunal adopted similar reasoning in *Premier National Bancorp*.¹⁰ The tribunal concluded that the Division of Taxation could not invoke the sham transaction doctrine to override the benefits of a grandfathering election, which was clearly a tax benefit provided by the Legislature. In the language of the administrative law judge (whose determination was affirmed by the tribunal):

The record revealed that one of the reasons for the enactment of the grandfather provision was to discourage companies that would have been affected adversely from the change without such election from moving to other states such as Delaware where they may have received tax-favored treatment. The Legislature made a decision to enact a provision to preserve the existence of corporate presence in New York. . . . [T]he Division is attempting to utilize its discretionary authority to essentially supplant the two statutes which govern this case. . . . The effect of this adjustment is to impermissibly disregard Investment Company's valid election, and the Division cannot use its discretionary authority as a substitute for amending the Tax Law to alter the effect of this election.¹¹

The New York State Tax Appeals Tribunal endorsed a similar opinion in *Haskell Edelstein*.¹² In that case an individual (a well-known tax professional, now deceased) protested New York City's adopting a regulation that provided that a parking tax exemption would become effective on the first day of the month following the taxpayer's providing the garage operator with an exemption certificate issued by the city. The statute, however, stated that the exemption would be available when the exemption certificate was presented to the garage operator.

¹⁰*Premier National Bancorp*, New York Tax Appeals Tribunal Docket No. 819746 (Aug. 2, 2007). (For the decision, see *Doc 2007-18688* or *2007 STT 157-18*.)

¹¹*Premier National Bancorp*, New York Division of Tax Appeals, Administrative Law Judge Determination, Docket No. 819746 (Apr. 27, 2006). (For the decision, see *Doc 2006-9487* or *2006 STT 99-13*.)

¹²TSB-D-90(7)S (New York Tax Appeals Tribunal, Feb. 8, 1990).

The tribunal said that the city, by imposing a beginning-of-the-month provision, was attempting to add an additional element to the regulation and was "unreasonable" and not authorized by the tax law or the city administrative code. Edelstein recouped his \$21.60.

The same approach should be followed in the context of the New York captive insurance companies, an area that has not yet been litigated. It cannot seriously be disputed that the New York State Legislature expressly created New York captive insurance companies to "help NYC [and the] state's business community."¹³ The press release announcing the New York captive insurance company legislation quotes then-Gov. George Pataki as saying, "Our policies of cutting taxes, controlling spending and eliminating red tape have strengthened the State's business climate. This bill reaffirms my commitment to pursuing policies that result in creating business opportunities and jobs in the State of New York."¹⁴ Likewise, the New York captive insurance company website lists "competitive tax/assessment rates" as one of the many reasons for forming a captive in New York.¹⁵ Accordingly, the Legislature created captive insurance companies to benefit the business community, including by providing tax benefits. Any attempt to deprive taxpayers of those benefits would be inconsistent with the intent of the Legislature and would be invalid under federal and state case law. Taxpayers cannot be faulted for creating what is completely consistent with what the New York Legislature contemplated and "was the thing which the statute intended."¹⁶

Conclusion

Regardless of whether common-law tax doctrines have any appropriate place in evaluating some tax issues, they are clearly improper in the context of ITBs. One would hope that courts and revenue departments will accept this and give legislatures the respect they deserve. ☆

¹³Pataki press release, Mar. 13, 2003.

¹⁴*Id.*

¹⁵Available at <http://www.ins.state.ny.us/website3/captives/capwhy.htm> (accessed Apr. 8, 2009).

¹⁶*Gregory v. Helvering*, *supra* note 1.