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Business Purpose and Economic Substance in State Taxation

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Introduction

The issue posed by the business purpose and economic substance doctrines is whether, and when, the literal language of a statute or regulation should be overridden because it leads to an inappropriate result. Courts have sometimes held that a transaction that fits within the literal language of a statute or regulation will not be respected for tax purposes, even though it may be respected for other purposes, if the transaction lacks a legitimate business purpose other than to achieve a tax objective or if the transaction lacks economic substance. Underlying those notions is the well-accepted principle of statutory construction that a statute's literal language will not be followed when it leads to an absurd result.[1]

The issue in the tax cases is broader than one of how to interpret an ambiguous statute. Proponents of the business purpose/economic substance concepts argue that as a general rule tax statutes are designed to apply to legitimate business transactions that are intended to accomplish business results apart from their tax consequences. In effect, they argue that every tax statute should be interpreted as if it included the language, "This provision applies only to transactions that have economic substance and a business purpose apart from their tax consequences." The countervailing consideration is taxpayers' legitimate need for certainty in planning transactions. Many argue that a taxpayer should be able to read a statute or regulation, assume that it means what it says, and plan transactions based on its literal language. A taxpayer should not have to psychoanalyze the drafters of a statute or a regulation to figure out what they would have said had they anticipated the transaction under consideration. It can be argued that the proper way to deal with a statute that reaches a result that one regards as inappropriate is to amend it and not to apply it in a manner that its literal language does not permit.

A taxpayer should not have to psychoanalyze the drafters of a statute or a regulation to figure out what they would have said had they anticipated the transaction under consideration.

Judges have had difficulty articulating the business purpose and economic substance doctrines, and the distinction between them is often blurred. It is inaccurate to say that the business purpose test is subjective and that the economic substance test is objective. Some transactions that have involved the actual transfer of huge amounts of money have been held to lack economic substance. The courts have generally held that the presence or absence of a business purpose is relevant in determining whether a transaction has economic substance.

The business purpose and economic substance doctrines have long been present in federal tax cases, but their appearance in the state and local tax area is relatively recent. State tax departments and state judges have become more sophisticated in recent years, particularly when faced with a variety of tax planning strategies that many of them have regarded as being abusive. They have looked to the federal case law and to what some have called the federal common law of taxation for concepts that can be applied in analyzing situations in which "things are seldom what they seem, skim milk masquerades as cream."[2]

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[1] *Williams v. Williams*, 23 N.Y.2d 592, 246 N.E.2d 333 (1969).

[2] Henry Gilbert and Arthur Sullivan, *HMS Pinafore*.

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Federal Tax Cases

A discussion of some of the leading federal cases involving the business purpose and economic substance doctrines will be helpful, since the state cases tend to be based on principles that were first enunciated by courts dealing with federal tax issues. This article will not discuss all of the federal cases but instead will focus on a few of the leading ones that seem particularly relevant in today's state and local tax world.

Gregory v. Helvering

The grandfather of the business purpose/economic substance cases is *Gregory v. Helvering*.[3]

The provisions of the Revenue Act of 1924 and their immediate successors contained no requirement that a corporation participating in a tax-free reorganization be engaged in an active business. They permitted taxpayers to make an end run around the dividend distribution provisions by having a corporation owning cash or marketable securities transfer them to a newly formed subsidiary, after which the subsidiary's stock was distributed to the shareholders tax free. The shareholders could then liquidate or sell the subsidiary, thus converting what in essence was a dividend distribution into a capital gains transaction. The infamous Evelyn Gregory did just that. She owned all the stock of United Mortgage Corp., which included among its assets 1,000 shares of the stock of Monitor Securities Corp. Gregory wanted United to distribute the Monitor stock to her, but she did not want to be taxed on a dividend. Instead, she caused United to form a new corporation, Averill Corp., and to transfer the Monitor shares to Averill in exchange for which all of the Averill stock was issued directly to Gregory, who immediately liquidated it, received the Monitor shares in liquidation, and sold them.

Gregory argued that the transaction was a reorganization under section 112(i)(1)(B) of the Revenue Act of 1928 (the predecessor to section 368(a)(1)(D) of the Internal Revenue Code of 1986) because it met the literal requirements of that provision. She said that she should be treated as if she had received a liquidating distribution from Averill, that her basis in the Averill shares should be the proportion of her cost in the United shares that the Monitor shares bore to the total assets of United, and that she should pay tax at capital gains rates on the difference. She treated the Monitor shares as if they had received a stepped-up basis in the liquidation of Averill, and she reported no gain on their sale. The IRS argued that the transfer of the Monitor shares to Averill was not a true reorganization. It ignored all the transactions involving Averill and treated the sequence of transactions as the payment of a dividend in the form of the Monitor shares by United to Gregory, on which she was required to pay normal tax at full value with no offset for basis.

Gregory prevailed before the Board of Tax Appeals. The board found that the transactions involving Averill actually happened, that their purpose was immaterial, and that they should be treated as a reorganization.[4]

The Court of Appeals for the Second Circuit reversed the board's holding in an opinion that has provided more quotable lines for both taxpayers and the Service than perhaps any other in the history of tax jurisprudence.[5] The court referred frequently to the business purpose concept, but it is not at all clear that the court regarded it as an independent test. Another reading of the opinion is that the court believed the lack of business purpose indicated that the transaction was in substance a dividend distribution. In other words, the court may have viewed the lack of business purpose as merely an evidentiary factor to be considered in applying the proposition that the tax consequences of a transaction should be governed by its substance rather than by its form.

In one frequently quoted passage, Judge Learned Hand seemed to reject business purpose as an independent requirement. He said:

> We agree with the Board and the taxpayer that a transaction, otherwise within an exception of the tax law, does not lose its immunity, because it is actuated by a desire to avoid, or, if one choose, to evade, taxation. Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes.[6]

Judge Hand went on to say that "if what was done here, was what was intended by section 112(i)(1)(B), it is of no consequence that it was all an elaborate scheme to get rid of income taxes, as it certainly was."[7]

After seemingly rejecting a separate business purpose requirement, Judge Hand went on to coin a phrase that has served as the basis of the test throughout the years. He said:

> The purpose of the section is plain enough; men engaged in enterprises — industrial, commercial, financial, or any other — might wish to consolidate, or divide, to add to, or subtract from their holdings. Such transactions were not to be considered as "realizing" any profit,

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[3]239 U.S. 465 (1935).

[4]*Gregory v. Commissioner*, 27 B.T.A. 223 (1932).
[5]*Helvering v. Gregory*, 69 F.2d 809 (2d Cir. 1934).
[6]*Id.* at 810.
[7]*Id.*

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because the collective interests still remained in solution. But the underlying presupposition is plain that the readjustment shall be undertaken for reasons germane to the conduct of the venture in hand, not as an ephemeral incident, egregious to its prosecution. To dodge the shareholders' taxes is not one of the transactions contemplated as corporate "reorganizations."[8]

Judge Hand also cited the legislative history of the 1924 act as indicating that the purpose of the reorganization provisions was to exempt from tax the gains from exchanges "made in connection with reorganization in order that ordinary business transactions will not be prevented."[9] He also cited cases establishing the continuity of interest[10] and continuity of business enterprise[11] requirements as standing for the proposition that a transaction that is really a sale should not be treated as a reorganization even though it literally falls within the statutory definition. Regarding those cases, Judge Hand said that the "violence done the literal interpretation of the words is no less than what we do here." [12]

The expression "for reasons germane to the conduct of the venture in hand" has reappeared in one form or another in regulations and court cases ever since and has served as the basis for the business purpose doctrine as it is understood today. In the context of the opinion, however, it is not at all clear that this is what Judge Hand had in mind. Read in conjunction with the language preceding it about the ability of taxpayers to plan transactions to save taxes and with the reference to avoiding shareholder taxes, the court arguably was not saying that the presence of a business purpose was an independent requirement but only that its absence indicated that the substance of the transaction was a dividend distribution and not a corporate readjustment. In rejecting the IRS's argument that Averill should be ignored, the court said:

All these steps were real, and their only defect was that they were not what the statute means by a "reorganization," because the transactions were no part of the conduct of the business of either or both companies; so viewed they were a sham, though all the proceedings had their usual effect.[13]

[8]*Id.* at 811.

[9]*Id.*

[10]*Pinellas Ice & Cold Storage Co. v. Commissioner*, 287 U.S. 462 (1933).

[11]*Cortland Specialty Co. v. Commissioner*, 60 F.2d 937 (2d Cir. 1932), *cert. denied*, 288 U.S. 599 (1933).

[12]69 F.2d at 811.

[13]*Id.*

The Supreme Court affirmed the Second Circuit.[14] The Court said that the statute required the transfer of assets to be made "in pursuance of a plan of reorganization" and did not contemplate a "transfer of assets by one corporation to another in pursuance of a plan having no relation to the business of either, as plainly was the case here." It went on to say:

Putting aside, then, the question of motive in respect of taxation altogether, and fixing the character of the proceeding by what actually occurred, what do we find? Simply an operation having no business or corporate purpose — a mere device which put on the form of a corporate reorganization as a disguise for concealing its real character, and the sole object and accomplishment of which was the consummation of a preconceived plan, not to reorganize a business or any part of a business, but to transfer a parcel of corporate shares to the petitioner.[15]

In conclusion, the Court said:

The whole undertaking, though conducted according to the terms of subdivision (B), was in fact an elaborate and devious form of [dividend] conveyance masquerading as a corporate reorganization, and nothing else. The rule which excludes from consideration the motive of tax avoidance is not pertinent to the situation, because the transaction upon its face lies outside the plain intent of the statute. To hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose.[16]

The Second Circuit's opinion in *Gregory* can be read either as viewing the absence of business purpose as a conclusive ultimate fact or as merely evidence in applying the substance-versus-form doctrine. The Supreme Court's opinion seems more clearly to assign it the more limited role. The Court seems to have believed that the transaction was in fact a dividend distribution and that the absence of a corporate business purpose proved that the parties regarded it as a mere distribution of corporate earnings.

Cases Interpreting *Gregory*

The cases that were decided in the few years after *Gregory* seem for the most part to have viewed it as a substance-versus-form case, although some opinions stressed its business purpose aspects.[17]

[14]*Gregory v. Helvering*, 293 U.S. 465 (1935).

[15]*Id.* at 469.

[16]*Id.* at 470.

[17]For discussions of those cases, see Spear, "'Corporate Business Purpose' in Reorganization," 3 *Tax L. Rev.* 225

(Footnote continued on next page.)

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Less than two months after the Supreme Court's decision, the district court in Massachusetts confronted a similar transaction, but there the controlled corporation that was formed with assets of the distributing corporation and the stock of which was distributed to the parent's shareholders remained in existence.[18] The court distinguished *Gregory* because Averill Corp. in *Gregory* never transacted business or did anything else but served solely as a vehicle for saving taxes for the distributing corporation's shareholder. The court said that the *Gregory* Court had held that "the transfer must be in pursuance of a plan of reorganization of corporate business and not a transfer of assets by one corporation to another in pursuance of a plan having no relation to the business of either."[19] The court upheld the tax-free nature of the transaction. It is unclear how it viewed the Supreme Court's rationale.

Judge Hand reflected the courts' uncertainty in an opinion written later that year in *Chisholm v. Commissioner*.[20] He seemed to view the Supreme Court's decision in *Gregory* as involving the substance-versus-form principle. In *Chisholm* Judge Hand said:

> The question always is whether the transaction under scrutiny is in fact what it appears to be in form; a marriage may be a joke; a contract may be intended only to deceive others; an agreement may have a collateral defeasance. In such cases the transaction as a whole is different from its appearance.[21]

Judge Hand went on to discuss *Gregory*. Referring to the parties in that case, he said:

> Had they really meant to conduct a business by means of the two reorganized companies, they would have escaped whatever other aim they might have had, whether to avoid taxes, or to regenerate the world.[22]

Referring to the role of business purpose, Judge Hand said:

> We may assume that purpose may be the touchstone, but the purpose which counts is one which defeats or contradicts the apparent transaction, not the purpose to escape taxation which the apparent, but not the whole, transaction would realize.[23]

Thus, Judge Hand seems to have viewed the presence or absence of the business purpose as evidence of whether the transaction was what it purported to be.

In an opinion written many years later, however, he emphasized the business purpose aspects of *Gregory*, holding that the case stood for the proposition that "in construing the words of a tax statute which describe commercial or industrial transactions we are to understand them to refer to transactions entered upon for commercial or industrial purposes and not to include transactions entered upon for no other motive but to escape taxation."[24]

The Supreme Court, commenting on *Gregory* a few years after the decision, said in *Helvering v. Minnesota Tea Co.*[25] that the case "revealed a sham — a mere device intended to obscure the character of the transaction."[26] That suggests that the Court regarded *Gregory* as being concerned with a factual determination of the substance of the transaction.

The Board of Tax Appeals, a few years later, cited *Gregory* as standing for the substance-versus-form concept in *Bass v. Commissioner*,[27] a case involving a recapitalization. In *Bass* a corporation with only common stock outstanding recapitalized, with the common shareholders surrendering their common stock in exchange for new common stock and preferred stock. A payment of a stock dividend of preferred stock on the outstanding common stock would have been taxable as an ordinary dividend. The board held that the transaction in substance was a distribution of a dividend of preferred stock and that the surrender of the old common stock in exchange for new common stock was a meaningless gesture. It cited *Gregory* for the proposition that the substance of a transaction controlled over its form.[28] The board cited the absence of a business purpose for the surrender of the old common stock as evidence that the substance of the transaction was merely a distribution of the preferred stock as a dividend.

On the other hand, some courts seem to have viewed *Gregory* as standing for the proposition that the existence of a business purpose is an independent requirement. For example, in *Lea v. Commissioner*,[29] shareholders of a corporation (the original Sperry Gyroscope Co.) were negotiating to sell its stock to an unrelated buyer. Some patents were

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(1947), and Bittker, "What Is 'Business Purpose' in Reorganizations?" 8 *N.Y.U. Annual Inst. on Fed. Tax* 134 (1950).

[18] *Bremer v. White*, 10 F. Supp. 9 (D. Mass. 1935).

[19] *Id.* at 12.

[20] 79 F.2d 14 (2d Cir. 1935).

[21] *Id.* at 15.

[22] *Id.*

[23] *Id.*

[24] *Commissioner v. Transport Trading & Terminal Corp.*, 176 F.2d 570, 572 (2d Cir. 1949), *cert. denied*, 338 U.S. 955, *reh'g denied*, 339 U.S. 916 (1950).

[25] 296 U.S. 378 (1938).

[26] *Id.* at 385.

[27] 45 B.T.A. 1117 (1941), *vacated*, 129 F.2d 300 (1st Cir. 1942).

[28] *Id.* at 1120.

[29] 96 F.2d 55 (2d Cir. 1938).

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owned by another corporation owned by the same shareholders, and the buyer asked that the patents owned by both corporations be put together in one new corporation. The patents of the second corporation were transferred to the new corporation on January 18, 1929. The buyer then realized that, if it acquired the stock of the new corporation, its depreciation of the patents would be limited to their historic basis and that the individual inventor might retain some rights to the patents. The buyer therefore asked that the new corporation be dissolved and that the patents be transferred to the individual shareholders, which was done on January 21, 1929.

The court rejected the IRS's argument that the organization and dissolution of the new corporation should be disregarded and that the distribution of the patents should be taxed as a dividend. It held that the transaction was a reorganization within the meaning of the same statute that was involved in *Gregory*. Although the new corporation lasted for only a short period of time, it was organized for a business purpose and was intended to operate indefinitely as a holding company for the patents. Since there was a business purpose for the organization of the new company and the distribution of its stock, *Gregory* did not apply.

In *Wellhouse v. Commissioner*,[30] the Tax Court, in dictum, said that a recapitalization was not a reorganization because it lacked a business purpose. A few of the corporation's shareholders had incurred debt obligations in connection with the purchase of their stock in the company. To enable them to pay off these obligations, the corporation recapitalized and offered to exchange preferred stock for common stock. The two shareholders who had the debt obligations were the only ones who accepted the exchange offer. On receipt of the preferred stock, they immediately transferred it to the creditor. The court said that "under the well crystallized doctrine of *Gregory v. Helvering* . . . there must be corporate business purpose in the transaction. We find none in the facts."[31] The only purpose for the transaction was to enable individual shareholders to pay off their debts, and that was not "germane to the conduct of the venture in hand."[32]

Recent Federal Tax Cases

In the last few years, the federal courts have been called on to address a number of cases involving aggressive tax strategies that have been adopted by corporations. In many cases, the strategies appear to have been prompted by a desire to achieve a tax objective, such as to reduce the tax impact of a large gain that the taxpayer had previously realized. Nevertheless, the transactions generally involved transfers of large amounts of money and other property and had "economic substance" in the sense that huge sums moved from one taxpayer to another.

The judges have struggled with those transactions. On the one hand, in a number of cases it has been clear that the judges believed the transactions were invented solely to achieve a tax result and should not be respected even if objectively they involved significant changes in economic position. On the other hand, taxpayers have argued forcefully and often convincingly that they should be allowed to assume that written rules mean what they say and that transactions that actually happened should be respected for tax purposes even if they were motivated by tax considerations. The recent opinions reflect that intellectual and emotional tension.

This article will not discuss all of the recent federal tax cases, but it will focus on a few that seem to have particular significance.

Cases involving a tax strategy designed to take advantage of the foreign tax credit illustrate the tension that has troubled the courts. In these transactions, a corporation buys American depository receipts representing stock of foreign companies before the record date for a dividend payment and soon thereafter enters into a contract to resell the stock ex-dividend for less than the taxpayer's initial purchase price, thereby generating a capital loss. The dividend received by the taxpayer is burdened by a foreign withholding tax obligation that causes the entirety of the transaction to produce a pretax loss. The company claims capital losses on the sales and also claims a foreign tax credit equal to the amount of the foreign withholding tax on the dividends received. That treatment is consistent with what was then the literal language of the statute.

The taxpayer's treatment of the transaction was upheld in *IES Industries, Inc. v. United States*.[33]

The district court, in a motion for partial summary judgment, held that the losses were not to be respected for tax purposes, finding that the overall transactions lacked economic substance because they did not result in any reasonable expectation of pretax profit. The court determined that the transactions were not compelled by business realities and had no practical economic effects. The court concluded that the transactions were structured solely to generate tax benefits and thus were shams. The

[30] 3 T.C. 363 (1944).

[31] *Id.* at 367.

[32] *Id.* at 368. The court went on to find for the taxpayer anyway, holding that no cash or stock dividend had been distributed and that the transfer of the preferred stock and the satisfaction of the debt did not result in the realization of gain.

[33] 253 F.3d 350 (8th Cir. 2001), *rev'g in part and remanding*, 2001-1 U.S.T.C. para. 50,470 (ND. Iowa 1999). The writer's law firm, McDermott Will & Emery LLP, represented the taxpayer in this case.

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court disallowed the claimed foreign tax credits, reasoning that the foreign tax payments were in effect fees paid to buy the tax credits and were not separable economically substantive items distinct from the underlying transactions.

The Eighth Circuit reversed, holding that the transactions had both economic substance and business purpose. The court said that it was not prepared to hold that a transaction should be treated as a sham merely because it did not involve "excessive risk." The court said that the taxpayer's "disinclination to accept any more risk than necessary in these circumstances strikes us as an exercise of good business judgment consistent with a subjective intent to treat the American depository receipt trades as money-making transactions." The taxpayer argued on appeal that rules should control tax consequences and that in planning transactions, taxpayers were entitled to rely on statutes as written. At the oral argument, taxpayer's counsel stated the case for not applying subjective notions of business purpose and economic substance in the following language:

> Our method of taxation is complex, but one important thing in its favor is that it works because it is rule-based. By that I mean our system is objective — the rules determine the results — as opposed to a subjective system where the results depend on more illusive criteria where transactions are evaluated after-the-fact based upon "smell test" results or whether the tax results seem undesirable or perhaps too beneficial or generous. . . . The rule-based system we are advocating places importance on what the taxpayer did and the attached economic consequences. This system forces both the taxpayer and the government to turn the same square corners and leads to a better system of taxation. Certainly what we suggest leads to more predictability, which itself is beneficial. We presume that Congress put [in] substantial effort and thought when enacting the rules we are about to discuss. If the rules reach a result that now seems undesirable, the rules should be changed by Congress.

The appeals court held that the economic benefit to the taxpayer before the foreign taxes were paid determined whether there was economic substance to the transaction. Because IES was the legal owner of the shares on the record date for the dividends, it was legally entitled to retain the benefits of ownership, including the dividends due, and therefore, the foreign tax credit. Although IES received the dividends net of foreign withholding taxes, it realized income in the full amount of the dividends. The entire amount of the dividends was income to IES and, hence, the transaction resulted in a pretax profit to the company. There was no lack of business purpose or economic substance.

The Tax Court, in *Compaq Computer Corporation v. Commissioner*, another case involving a similar transaction, had found for the IRS.[34] The court's analysis emphasized subjective elements. A large part of the opinion was devoted to a discussion of the process by which the taxpayer went into the transaction, emphasizing the lack of investment analysis and due diligence and the taxpayer's paramount desire to obtain tax benefits.

On appeal the Fifth Circuit reversed, relying heavily on the Eighth Circuit's opinion in *IES Alliant*.[35] The court held that the transaction would be respected because it had a nontax business purpose and affected the taxpayer's economic position, regardless of whether it may have been primarily motivated by a desire to achieve tax benefits.

United Parcel Service of America, Inc. v. Commissioner involved a restructuring of corporate operations.[36] The court's reasoning has implications for many state and local tax planning strategies, including the use of holding companies for intangible assets.

UPS collected fees from customers desiring to be reimbursed for damages to packages exceeding $100 (excess value fees). It paid the fees to an insurance company (National Union), which reinsured the risk to a Bermuda company (OPL) owned by UPS's shareholders.

> ***In effect, the Eleventh Circuit said that a taxpayer was free at the establishmentof a business to organize it in a tax-efficient manner and that it can change its structure to a more tax-efficient one later on.***

The IRS challenged the transaction, arguing that it involved an assignment of income. It also argued that income should be reallocated to UPS under section 482 of the Internal Revenue Code, which generally authorizes the Service to reallocate items of income, deduction, and loss among related parties when they deal with each other at other than arm's length.

The Tax Court ruled in favor of the IRS, based on the assignment of income theory, and it did not address the IRS's section 482 argument. Applying

[34]113 T.C. 214 (1999).

[35]253 F.3d 350 (8th Cir. 2001).

[36]254 F.3d 1014 (11th Cir. 2001), *rev'g and remanding*, T.G. Memo 1999-268.

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the assignment of income doctrine, the court said that UPS directly conducted the shipping business that gave rise to the ability to earn the income from the parcel business but transferred the ability to profit from the parcel insurance business to a tax haven affiliate.

UPS put forth a number of purported business reasons for the restructuring of the fees, including that without that restructuring, the payments would run afoul of restrictions under some state insurance laws, that it intended to leverage the profits into the creation of a new reinsurer that could become a full-line insurer, and that by restructuring the fees it protected its transportation business from the risk of increased liabilities. The Tax Court found no credible evidence that the restructuring would achieve the stated goals, and it concluded that there was no business purpose for the transaction. The court said that economically UPS was in substantially the same position after the restructuring as it was before it, but through the arrangements it was able to exclude the payments from income.

The Court of Appeals for the Eleventh Circuit reversed and remanded the case, instructing the Tax Court to address the section 482 issue.

Although the appeals court discussed business purpose concepts, it rejected the IRS's economic substance analysis. The court said, in language that will be significant in the state tax area, that the requirement of a business purpose did not mean that a transaction had to be free of tax considerations. It said that a transaction would be deemed to have a business purpose when it involved a restructuring of a bona fide profit-seeking business, even if the restructuring was tax motivated. In effect, the court said that a taxpayer was free at the establishment of a business to organize it in a tax-efficient manner. If it does not do so initially, it can change its structure to a more tax-efficient one later on. The new structure will be respected if it has economic reality and is intended to carry on genuine business operations, even if the only reason for the restructuring was to save in taxes.

If several employees are involved in a transaction and each of them has different reasons for believing that the corporation should engage in it, whose purpose is the corporation's purpose?

One issue that has not been focused on as much as it should be is how one determines a corporation's purpose. A corporation is an inanimate entity and it functions only through its employees, directors, and agents. If several employees are involved in a transaction and each of them has different reasons for believing that the corporation should engage in it, whose purpose is the corporation's purpose? I have been maintaining in speeches for years that, as a matter of corporate governance, a corporation's purpose is the purpose of the people who make the decision to commit the corporation to engage in the transaction and not necessarily that of the people who recommend to the corporate decision-makers that the transaction be undertaken. The U.S. District Court for the Southern District of Texas has held just that in *Shell Petroleum Inc. v. U.S.*[37]

Shell entered into a complex transaction involving auction-rate preferred stock. Although the transaction was initiated by the company's tax department to save taxes, the tax people did not mention this when they submitted the proposal to the company's management for decision. In finding for the taxpayer, the court held that a corporation's purpose for taking any action is the purpose of its decision-makers. In this case, the people who made the decision for the corporation to enter into the transaction were ignorant of the tax considerations, and their intent — not that of the tax people who conceived of the transaction initially — was imputed to the corporation.

Judges of the Court of Federal Claims have addressed business purpose and economic substance recently in the context of lease-in-lease-out (LILO) and sale-in-lease-out (SILO) transactions.

In *Consolidated Edison Company of New York, Inc. v. U.S.,* the court upheld a LILO transaction. Although these transactions had been widely marketed as tax savings devices, the taxpayer introduced substantial testimony from corporate general business executives, including the chief executive officer, about the company's overall business strategies and how the LILO transaction played a role in advancing those strategies. The provision of electricity and other utilities had recently been deregulated and the company needed to expand its operations both domestically and internationally. Through the LILO, the company invested in a Dutch utility plant to expand its international investments, diversify its assets, and develop international strategic alliances. The court held that the transaction had significant economic substance.[38]

On January 8, 2010, the Court of Federal Claims struck down SILO transactions in *Wells Fargo & Co. v. U.S.*[39] The transactions at issue all involved circular flows of funds so that, while the taxpayer purported to acquire ownership of government property and lease it back to the government, in fact,

[37]2008-2 U.S. Tax Cas. (CCH) P50,422; 102 AFTR 2nd (RIA) 5085 (S.D. Tex. 2008).

[38]Court of Federal Claims, No. 06-305T (2009).

[39]Court of Federal Claims, No. 06-628T (2010).

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everything was done by book entry and no money actually changed hands. Although the government in theory did not have to buy back the property at the end of the lease, the economics of the arrangements were such that the court felt that a buy-back was compelled by the circumstances. The court found that the taxpayer never acquired the benefits and burdens of ownership of the properties in question, having no upside and no downside in case of changes in value. It also found that the purported loans that produced interest deductions were fictitious because the money was returned immediately to the purported lender. Based on these findings, the court could have disallowed the deductions without getting into questions of economic substance and business purpose, but it went on to find that, in addition to these defects, the transactions lacked business purpose and economic substance. The court said that it would have no problem with a regular business transaction that was structured in a certain way to produce tax benefits, but it could not tolerate a transaction that was devised in the first place solely to produce tax benefits. The court was clearly offended by the transaction. Judge Wheeler said "the SILO transactions here are offensive to the Court on many levels." "Although well disguised in a sea of paper and complexity, the SILO transactions essentially amount to Wells Fargo's purchase of tax benefits for a fee from a tax-exempt entry that cannot use the deductions." The judge said that "[t]he Court has little sympathy for those who have lost out as a result of this decision."

State and Local Tax Cases

The state and local tax cases addressing issues of economic substance and business purpose have shown no more intellectual rigor than have the federal cases. The courts have tended to use the concepts interchangeably to attack transactions that they did not like. One suspects that judges apply the "smell test" in deciding whether a transaction will be respected and then use the words "business purpose" and "economic substance" to intellectualize the decisions reached by an unintellectual process. As one judge said to me at a cocktail party in describing a case he had recently heard at oral argument: "Pete, his lawyer had all the best of the legal arguments at oral argument the other day, but there is no way we are going to let that SOB get away with that!" And they didn't.

State and local tax cases have addressed the issues in a variety of contexts.

Cases Addressing Whether to Ignore a Transaction and Deny a Deduction

Several Massachusetts cases have involved intangible holding companies.

In *Syms Corp. v. Commissioner of Revenue*, a retailer formed a company in Delaware to hold its trademarks and license them to the retailer.[40] The holding company held the royalty payments for a few weeks and then returned them to Syms as tax-free dividends. The accountant advised the company that the restructuring would save taxes and that state revenue departments were unlikely to pick it up.[41] The retailer purported to "pay" royalties to the holding company before the holding company was formed.

The Massachusetts Supreme Judicial Court relied on the Appellate Tax Board's findings "that the transfer and license back transaction had no practical economic effect on Syms other than the creation of tax benefits, and that tax avoidance was the clear motivating factor and its only business purpose." The court said that under these circumstances, the royalty payments were not "ordinary and necessary" business expenses and could not be deducted. The court said that the value of the trademarks had been created entirely by Syms and that, even after their transfer and the payment of royalties, Syms continued to pay the expenses associated with owning the trademarks, including the legal expenses incurred in maintaining them.

The Supreme Judicial Court took a different tack in upholding an intangible holding company arrangement in *Sherwin-Williams Co. v. Commissioner of Revenue*.[42] The court held that an intangible holding company should be respected, reversing the Appellate Tax Board, and the operating company was allowed to deduct the royalties paid to the holding company.

The court said that the holding company arrangement had economic substance because it changed the economic relationships among the parties. Royalties were retained by the holding company and invested and were not immediately repaid to the parent, as was the case in *Syms*. Citing *United Parcel Service v. Commissioner*, the court said that a legitimate reorganization of an ongoing business that affected economic relationships would be respected, even if it was tax motivated. Under the Massachusetts application of the sham transaction

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[40] 436 Mass. 505 (2002). For the decision, see *Doc 2002-8734* or *2002 STT 71-23*. *See* Peter L. Faber, "Business Purpose and the *Syms* Case in Massachusetts — the Interplay of Federal and State Tax Concepts, " *State Tax Notes*, May 13, 2002, p. 643, *Doc 2002-11453*, or *Doc 2002 93-15*.

[41] The accountant noted that an exception might be the New York State Department of Taxation and Finance, which in his view tended to be more sophisticated than other revenue departments.

[42] 438 Mass. 71 (2002). For the decision, see *Doc 2002-24629* or *2002 STT 213-20*. *See* Peter L. Faber, "Use of Intangible Company Upheld as Business Reorganization: Massachusetts Gets It Right in *Sherwin-Williams*, " *State Tax Notes*, Dec. 9, 2002, p. 671, *Doc 2002-26833*, or *2002 STT 236-20*.

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doctrine, the court said that a taxpayer would prevail if it could "demonstrate that the reorganization results in 'a viable business entity,' that is one which is 'formed for a substantial business purpose or actually engage[s] in substantive business activity.'"

The Appellate Tax Board, a body not noted for pro-taxpayer sympathies, upheld an intangible holding company arrangement in *Cambridge Brands, Inc. v. Commissioner of Revenue*.[43] In that case, an operating company engaged in manufacturing and selling candy (a subsidiary of Tootsie Roll Industries Inc.) was allowed to deduct royalties paid to a holding company. The board noted that the intellectual property had never been owned by the taxpayer. When the business was acquired by Tootsie Roll, the intellectual property was acquired by a separate subsidiary from the subsidiary that acquired the other assets. That was consistent with the structure that Tootsie Roll had used in connection with other businesses. The board said that this was a significant distinction between the facts in *Cambridge Brands* and those involved in *Syms*. Further, unlike *Syms*, there was no mismatch of expenses in which one entity paid license fees to another entity while still paying all of the expenses of maintaining the trademarks. There was no circular flow of funds.

According to the board, a business reorganization that resulted in tax advantages would be respected if the taxpayer could demonstrate that the reorganization resulted in a viable business entity, one formed for a substantial business purpose or that actually engages in substantive business activity.

A few decisions in Connecticut have been sympathetic to taxpayer arguments that structures should be respected.

In *SLI International Corp. v. Crystal*, commissions paid to a sister corporation, a foreign sales corporation (FSC) under the IRC, were respected because the expenses were incurred for a legitimate business purpose and were not merely a device for the payment of dividends to the corporations' common parent.[44] The taxpayer entered into a marketing contract to pay the FSC commissions on sales of goods to buyers outside the United States. Under special provisions of the IRC, the FSC paid U.S. tax on only 8/23 of its foreign-source income and was not subject to tax in Connecticut. The later payment of dividends from the FSC to the parent was not subject to Connecticut or federal tax.

The commissioner of revenue services argued that a portion of the commission was not deductible, but the Connecticut Supreme Court allowed the taxpayer to deduct the entire commission because the arrangement had a legitimate business purpose and an actual economic effect. The FSC was a legitimate business entity because it received income from sources other than the taxpayer, had a permanent place of business in the U.S. Virgin Islands, maintained business records, and paid its own expenses.

In *Carpenter Technology Corp. v. Department of Revenue Services*, the Connecticut Supreme Court allowed the deduction of interest payments on an intercompany loan, holding that the creation of the subsidiary that received the payments had a valid business purpose and that the subsidiary had economic substance. The case involved a capital contribution by the parent corporation to a new subsidiary and an immediate loan back to the parent, creating an interest payment obligation for the parent.[45] The court said that the subsidiary had economic substance because it was viable and functioning and was capitalized with enough assets to enable it to withstand the claims of potential creditors.

> ***The Connecticut Supreme Court held that a subsidiary had economic substance because it was viable and functioning and was capitalized with enough assets to enable it to withstand the claims of potential creditors.***

Interestingly, the New York courts came to a contrary conclusion on identical facts.[46] The legal issue was slightly different, however, because of a difference in other statutory provisions. The parent had formed the subsidiary to own foreign entities so as to protect its domestic business assets from liabilities relating to conducting business in foreign countries. The New York court found that the only reasonable explanation for contributing the money to the subsidiary and immediately borrowing it back was to obtain a double tax benefit. The parent would gain tax-exempt income from the subsidiary under a provision of the New York state tax law that provides that taxable income does not include interest, dividends, or gains from subsidiaries, while the parent could obtain a deduction for the interest payments made to the subsidiary. Although capitalizing the subsidiary with enough assets to provide the economic substance necessary to "protect Carpenter's business assets from liabilities related to

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[43]Massachusetts Appellate Tax Board No. C259013(2003). (For the decision, see *Doc 2003-17023* or *140-14*.)

[44]236 Conn. 156 (1996). (For the decision, see *Doc 96-6046* or *96 STN 44-2*.)

[45]772 A.2d 593 (Conn. 2001). (For the decision, see *Doc 2001-17382* or *2001 STT 121-4*.)

[46]*Carpenter Technology Corp. v. Commissioner of Taxation and Finance*, 745 NYS 2d 86 (3rd Dep't 2002). (For the decision, see *Doc 2002-15574* or *2001 STT 128-14*.)

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conducting business in foreign countries" was a legitimate business purpose for forming and funding the subsidiary, that alone did not negate a conclusion that the interest payments were nondeductible expenses attributable to subsidiary capital.

Cases Ignoring Separate Existence of a Corporation

State courts have been willing to disregard the existence of a corporation when its creation and operation did not serve legitimate business purposes or have economic substance.

In *General Mills, Inc. v. Commissioner of Revenue*, a corporation formed a holding company to which it transferred intangible assets. Shortly afterward, the holding company sold the assets. The Massachusetts Supreme Judicial Court disregarded the transfer to the holding company and held that the parent was taxable on the gain.[47] The taxpayer argued that the creation of the subsidiary and the series of transfers were undertaken to "obtain certain advantages in the international market and advantages under certain international accounting practices." The court said that the step transaction doctrine would apply only if each step had "independent economic significance, is not subject to a tax as a sham, and was undertaken for valid business purposes and not mere avoidance of taxes." On the facts before it, the court found that the intermediate transfer to the holding company "served no legitimate business purpose and was designed solely to avoid Massachusetts tax."

In *HMN Financial, Inc. and Affiliates v. Commissioner of Revenue*, the Minnesota Tax Court ignored the creation of a real estate investment trust by HF Bank.[48] HF Bank transferred mortgage loans to the REIT and transferred the REIT's common stock to HF Holdings, a wholly owned subsidiary. HF Bank continued to manage, service, and collect on the loans, which it had originated, even though they were nominally owned by the REIT. After collection, HF Bank transferred the interest income to the REIT, less a service fee. The REIT immediately dividended the income to HF Holding, which, in turn, immediately dividended it back up to HF Bank. The tax purpose of the arrangement was to convert taxable interest income from the mortgages into tax-free dividend income.

The court had little difficulty in concluding that the arrangement was a sham and should be ignored. The alleged business purposes advanced by the taxpayer were found not to be credible. The court viewed the arrangement as a tax avoidance scheme that lacked economic substance.

[47] 440 Mass. 154 (2003). (For the decision, see *Doc 2003-20614* or *2003 STT 181-17*.)

[48] Minnesota Tax Court No. 7911-R (2009).

The Virginia Department of Revenue ignored the formation of two subsidiaries to which the taxpayer transferred software and from which the taxpayer licensed the software back in return for royalties.[49] The subsidiaries lent the amounts received under the royalty payments back to the taxpayer. The commissioner concluded that the subsidiaries were shell corporations that were wholly controlled and dominated by the parent and that therefore they lacked economic substance.

Cases Addressing Whether to Require Combined Returns

The New York state courts have applied the economic substance and business purpose doctrines in the context of determining whether related corporations should be required to file combined returns. The cases have involved the intersection of the common-law doctrines and Department of Taxation and Finance regulations that established objective standards for combination. Under the regulations then in effect, related corporations could be forced to file combined returns in New York only if they were linked by 80 percent stock ownership, were engaged in a unitary business, and separate filing would have distorted the companies' New York incomes.[50] Most of the cases involved situations in which the stock ownership and unitary business requirements were clearly met, so the point at issue was whether separate filing would result in distorting the corporations' New York incomes. That in turn depended on whether dealings between the corporations met arm's-length standards. In making those determinations, the courts generally applied the U.S. Treasury regulations adopted under section 482 of the IRC.

> ***The New York state courts have applied the economic substance and business purpose doctrines in the context of determining whether related corporations should be required to file combined returns.***

In *Toys "R" Us-NYTEX, Inc.*, the New York City Tax Appeals Tribunal held that combined returns were not required between a taxpayer and three

[49] Rulings of the Tax Commissioner, PD 95-229 (Virginia Department of Revenue 1995).

[50] 20 NYCRR sections 6-2.1 through 6-2.3. The New York statutes have since been amended to eliminate the distortion requirement. Under current law, related corporations engaged in a unitary business must file combined returns if there are substantial intercorporate transactions, without regard to whether those transactions are conducted at arm's length.

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nontaxpayer corporations — one that owned trademarks and trade names, one that owned mortgages on property owned by related corporations, and one that owned the stock of several subsidiaries and that made loans to related corporations — even though the stock ownership and unitary business requirements were met and there was a presumption of distortion because of the existence of substantial intercompany transactions. The taxpayer proved that the dealings between the companies met arm's-length standards, and that therefore there was no distortion under the regulations.[51]

The Department of Finance argued that income would not be properly reflected by separate filing because the original transfers of the intangibles to the subsidiaries lacked economic substance. The tribunal held that that was irrelevant. It concluded that under the regulations the absence of distortion meant that combined returns could not be required even though the arrangement might have lacked a business purpose or economic substance. It said, in effect, that those considerations were irrelevant.[52]

The New York state courts came to an opposite conclusion in *Sherwin-Williams Co. v. Tax Appeals Tribunal*.[53] That case involved the same facts as the Massachusetts *Sherwin-Williams* case, but in New York the legal context was whether Sherwin-Williams and its intangible holding companies could be compelled to file combined returns. (In Massachusetts the issue had been whether the royalties were deductible.) The taxpayer argued that there were business purposes for the arrangement, including advantages of incorporating in Delaware, the ability to use the trademark companies as shields in the event of a hostile takeover attempt, the ability to use the companies as investment and financing vehicles, and the insulation of the trademarks from the petitioners' liabilities. The court held that all those objectives could have been achieved without forming the holding companies. Because of the presence of substantial intercompany transactions, distortion from separate filing was presumed, and the court held that, because of the lack of economic substance and a nontax business purpose, the taxpayer had failed to rebut the presumption of distortion.

The court's reasoning is mystifying. The regulations provided that combined returns would be required only if separate filing would distort the New York incomes of the corporations. If the dealings between the corporations met the arm's-length standards of section 482, it is hard to see why the absence of a business purpose would affect the application of the regulations. If the court had said that combination could be required absent a business purpose for having separate corporations, without regard to whether arm's-length standards were met, that would be logical and understandable, but the court purported to apply the regulations, holding that the absence of a nontax business purpose meant that separate filing would distort the corporations' incomes. There may be some logic here, but it is hard to find.

Nevertheless, *Sherwin-Williams* is now the law of New York, and since the New York City Tax Appeals Tribunal is required by law to follow decisions of the State Tax Appeals Tribunal, *Sherwin-Williams* may have effectively overruled *Toys "R" Us*.

Sherwin-Williams has been followed in other cases.[54]

State Legislation Addressing Economic Substance

If one concedes that the economic substance and business purpose doctrines have a proper place in tax jurisprudence, where should they appear in the tax world?

Until relatively recently, the doctrines were the exclusive tools of the courts. Although, as indicated above, the courts have not been intellectually rigorous in applying them, in most cases their application, or at least the result of their application, has been reasonably predictable. In fact, the fuzziness of their outlines and reach have acted as deterrents against abusive taxpayer behavior. In my view, the doctrines should remain part of the common law of taxation and should not be reduced to legislation. The incorporation of the doctrines in statutes could have the effect of curtailing their use by the courts, and statutory language is always subject to avoidance by clever practitioners.

Despite that possibility, several state legislatures have attempted to codify the business purpose and economic substance doctrines. Whether that will be successful in reducing abusive behavior is unclear.

In Ohio, for example, the General Assembly has given the tax commissioner the power to disregard sham transactions in determining a taxpayer's tax liability. A sham transaction is defined as any transaction or series of transactions that has no economic substance because its only purpose is to obtain tax

[51]The New York City regulations at the time were substantially identical to the New York state regulations.

[52]NYC Tax Appeals Tribunal, TAT (E) 93-1039 (GC) (2004). (For the decision, see *Doc 2004-1164* or *2004 STT 17-13*.)

[53]784 NYS 2d 178 (Appellate Division 3d Dep't 2004), affirming N.Y.S. Tax Appeals Tribunal, DTA No. 816712 (2003). (For the decision, see *Doc 2004-21199* or *2004 STT 215-11*.)

[54]*See, e.g.*, *The Talbots, Inc.*, NYS Tax Appeals Tribunal, DTA No. 820168 (2008); *Lowe's Home Centers, Inc.*, NYS Division of Tax Appeals, DTA No. 818411 (2004); *Kellwood Co.*, NYS Tax Appeals Tribunal, DTA No. 820915 (2009).

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benefits.[55] To disregard a transaction under that provision, the tax commissioner must prove that it is a sham, unless the transaction is between members of a controlled group, in which case the burden of proof is on the taxpayer.

The incorporation of the doctrines in statutes could have the effect of curtailing their use by the courts, and statutory language is always subject to avoidance by clever practitioners.

The statute in Massachusetts appears to overrule *Sherwin-Williams* by requiring both a business purpose and economic substance for a transaction to be respected. Moreover, the business purpose must be commensurate with the tax benefits.[56]

The California statutes impose a penalty on tax understatements resulting from transactions lacking economic substance. A transaction will lack economic substance unless it has a "valid nontax California business purpose."[57]

Conclusion

What are we to make of this mess? The cases have failed to develop reliable guidance. It appears that the smell test reigns supreme and that the attempts to explain its application in intellectually satisfying terms have failed.

Perhaps the situation would be improved if we got away from the "business purpose" and "economic substance" terminology and tried to express the law in this area in more specific principles. It is clear that under current law some transactions that lack a nontax business purpose will, and should, be respected. For example, a decision to capitalize a corporation in significant part with debt rather than stock is often made for the sole purpose of obtaining the benefit of interest deductions on the investors' return. From the corporation's standpoint, without regard to taxes, debt is rarely preferable to stock because interest on debt, unlike dividends on stock, must be paid regardless of the circumstances. Nevertheless, if a corporation is not thinly capitalized, everyone would agree that shareholder debt should be treated as debt for tax purposes even if the reason for using it rather than stock was to obtain tax benefits.

On the other hand, some transactions that clearly have economic substance in the sense that they involve the actual transfer of huge amounts of money have properly been disregarded because they were tax avoidance scams that had no commercial function.

Let me suggest some principles that may be helpful in resolving disputes.

I think that everybody could agree that sham transactions and entities should be ignored. A corporation that has no employees or assets and that purports to outsource all of its functions to related parties should be ignored, regardless of whether its formation has a business purpose.

In a slightly more controversial vein, I would submit that a transaction that has economic substance in that it involves the movement of significant assets and liabilities among entities, but that is intended to create a tax deduction or credit to offset unrelated income, should be ignored, but not because of the economic substance doctrine.

Many intangible holding companies do not outsource all of their functions, and there is no reason why they should not be respected.

In accordance with *UPS* and the Massachusetts *Sherwin-Williams* case, a transaction that involves a reorganization of a legitimate business or investment operation and that does not involve sham entities should be respected, even if its only purpose is to bring about a more efficient tax structure. It is generally accepted that a company can organize its business among different legal entities for the purpose of saving taxes. That being the case, a company that adopts a poor tax structure at the outset should not be condemned to live with its mistake forever. It should be able to change to a more efficient tax structure even if the only reason for the reorganization is to save taxes.

How would an intangible holding company fare under those principles? The answer is: it depends. If an intangible holding company has employees, administers the intangible assets, and does not pay all of its income back to its parent corporation as dividends or loans, there is no reason why it should not be respected even if saving taxes was a principal or the principal purpose for forming it. The writer has seen many intangible holding companies that did not outsource all of their functions, and there is no reason why they should not be respected. However, the shell corporations that have been marketed by some aggressive Delaware service providers should be struck down, as they have been. ✰

[55] R.C. 5703.56.
[56] Massachusetts General Laws Chapter 62C, section 3A.
[57] Calif. Revenue and Taxation Code section 19774.

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