The Economic Substance Doctrine in State Taxation
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The Economic Substance Doctrine
- *Gilbert v. Commissioner*, 248 F.2d 399 (2d Cir. 1957) (Hand, J., dissenting)
- Creates the Economic Substance Doctrine
- Two-step analysis
  1. Did the transaction occur for nontax purposes, and, if so,
  2. Did the taxpayer intend the transaction to appreciably affect his beneficial interest other than to reduce tax
- Articulates the justification for the Economic Substance Doctrine
  - To prevent a taxpayer from construing a jurisdiction’s tax statutes in a self-defeating manner
  - That is, the purpose of the Code is not to provide an escape from the liabilities it imposes
- Significance
  - Changes the analysis from a “question of law” (what did Congress intend) to a “question of fact” (did the taxpayer intend the transaction to appreciably affect his beneficial interest)
    - Expands *Gregory v. Helvering* (applies to structural provisions of tax code) and limits *Gregory v. Helvering* (avoids purposeful statutory interpretation)
    - Shifts the burden of proof to the taxpayer
  - Adopted by the U.S. Supreme Court in *Knetsch v. United States*, 364 U.S. 361 (1960)
Issue

- **Question:** Why can I predict the results of federal economic substance cases but not state economic substance cases?
- **Answer:** State tax administrators and courts raise economic substance challenges to multi-jurisdiction capital competition
- Reason this doesn’t work for the states:
  - The Economic Substance Doctrine was never intended to apply to avert the threat of another jurisdiction’s tax laws to a state’s public fisc
    - More appropriate tools include addback statutes, combined reporting, and transfer pricing
  - Applying the Economic Substance Doctrine in this context cannot produce predictable results

**Limitations on the use of the Economic Substance Doctrine**

- It is easier to define the scope of the Economic Substance Doctrine by determining when it cannot apply
- **The Overt Transaction Limitation**
  - The Commissioner may only apply the Gilbert test to an “overt transaction” and not to an “act of forbearance on the taxpayer’s part,” such as postponing the realization of gain or loss by delaying the sale of an appreciated or depreciated asset.
- **The Characterization of Asset Limitation**
  - The Commissioner may not, except in unusual circumstances, disregard the character or identity of an asset.
- **The Juridical Person Limitation**
  - The principle that a corporation that actually engages in business is a juridical person under the tax law
- **The Self-Dealing Limitation**
  - The Commissioner may lack authority to recharacterize transactions which take place between unrelated parties (i.e., the Gilbert test may only be applied to instances of “self-dealing”).
  - Modern economic substance jurisprudence has substantively altered this limitation. Today, the inclusion of an unrelated third-party does not preclude assertion of the Economic Substance Doctrine. In certain instances, the use of an unrelated tax-indifferent third party is, in many respects, analogous to self-dealing. After Frank Lyon, the emphasis in economic substance cases shifted from the relationship of the parties involved to the transaction’s actual economic effects on those parties. A transaction that creates a tax loss or that creates a deduction that is not matched by an item of taxable income received by another party is particularly suspect, regardless of the relationship between the parties involved.
• **Today, it is best to rephrase this limitation as an authorization:** The Commissioner has the authority to recharacterize or strip the tax benefits from a transaction that takes place between unrelated or related parties if the transaction involves a negotiated price or other arrangement and the transaction creates a tax benefit that is not matched by an item of income taxable by the United States.

• **The In Favor of the Commissioner Limitation**
  - The most important limitation on the use of the Economic Substance Doctrine is that the *Gilbert* test only operates in favor of the Commissioner.

• **Legislatively Intended Tax Benefits**
  - The Economic Substance Doctrine is an interpretative tool that maintains the structural integrity of the Code. The Economic Substance Doctrine does not apply to legislatively intended tax benefits, i.e., benefits supported by the text, intent, and purpose of the Code.

• **The Ordinary Business Operations Limitation**
  - The ordinary course of business limitation allows taxpayers to take advantage of loopholes that naturally occur in the course of business operations. In contrast, the Economic Substance Doctrine operates to disallow the tax benefits from transactions manufactured to create the circumstances in which the loopholes arise. Syndication of those transactions makes them even more egregious and more likely to be found to lack economic substance.

• **The Structural Integrity of the Tax Code Limitation**
  - The Economic Substance Doctrine is a mechanism for maintaining the structural integrity of the Code. Thus, a transaction that is consistent with the Code’s structure should withstand an economic substance challenge. In contrast, a transaction that violates a fundamental principle of the Code is unlikely to withstand scrutiny under the Economic Substance Doctrine.

• **Single Jurisdiction Limitation**
  - A review of the state tax Economic Substance Doctrine jurisprudence does not indicate the existence of any additional limitations on the use of the Economic Substance Doctrine in state tax jurisprudence. Nevertheless, because of the confusion surrounding the application of the Economic Substance Doctrine to transactions entered into as a result of multi-state capital competition, it is necessary to articulate an additional limitation that prohibits an economic substance challenge to multi-jurisdiction capital competition. This limitation is appropriate because use of the Economic Substance Doctrine in that context creates considerable uncertainty for both taxpayers and tax administrators. These uncertain results are due to the fact that a court must contort the Economic Substance Doctrine in unintended ways should it wish to declare that a transaction that complies with the text, intent, and purpose of a state’s tax law lacks economic substance. The disparate holdings in *Sherwin-*
Williams (MA) and Sherwin-Williams (NY) illustrate that a litigant cannot reliably predict the results of an economic substance challenge in that instance.

Relevant State Tax Cases

- **Perplexing paradoxes in recent state cases**
  - A corporation that lacks the economic substance to exist as a separate business entity but exists for tax purposes?
  - A subsidiary that owns its parent?
  - A partnership that is its own partners?

- **Risks and Opportunities**
  - Federal and state decoupling
    - Debt for federal tax purposes but equity for state law (tax and otherwise?) purposes
    - Bankruptcy consequences
  - Different federal and state combined or consolidated groups?
  - An LLC that is a partnership for federal income tax but treated as a disregarded entity for state tax?

Example – Cash Management

- Parent sweeps cash from its subsidiaries and uses the cash to pay its subsidiaries expenses as well as to fund Parent’s own operations
  - Sub A generates cash in excess of its expenses. Parent records the excess cash swept as a loan from Parent to Sub A and Parent pays Sub A interest on the loan.
  - Sub B’s expenses exceed the cash it generates. Sub B records a loan to Parent and Sub B pays Parent interest on that loan.
- State X court, ostensibly relying on the Economic Substance Doctrine, issues broad opinion that the loans described above are not “bona fide” debt for state law purposes.

- **Consequences**
  - **Solution One – The Obvious Solution**
    - Loan from Sub A to Parent
- The loan proceeds Parent receives from Sub A are actually a distribution (dividend, then return of capital, then capital gain)
- The interest Parent pays Sub A is reclassified as a capital contribution

### Loan from Parent to Sub B
- The loan proceeds Sub B receives from Parent are actually a capital contribution
- The interest Sub B pays to Parent is a distribution

### Issue
- Loan proceeds and interest payments are reclassified differently depending on each Subs’ cash position

### Unintended Consequences
- Parent’s State X basis in stock of Subs now different from basis in stock federal tax and for other states
- In the event Parent desires to divest ownership of business it could be confronted with large gain on sale for State X tax purposes due to the lack of basis
- Could cause debt covenant issues if a Sub has loans with third parties
- Could have adverse franchise tax issues if State X also levies a net worth tax
- Administrative complexity results from having to track basis difference

#### Solution Two – I’m My Own Grandpa

### Loan from Sub A to Parent
- The loan proceeds Parent receives from Sub A are actually a capital contribution to Parent by Sub A, i.e., Sub A takes an ownership interest in Parent
- The interest Parent pays Sub A is reclassified as a distribution

### Loan from Parent to Sub B
- The loan proceeds Sub B receives from Parent are actually a capital contribution
- The interest Sub B pays to Parent is a distribution

### Issue
- This solution solves the classification problem of Solution One. The loan proceeds and interest payments are reclassified consistently, i.e., reclassification is not dependent on a subsidiary’s cash position.
- This solution may make more sense than Solution One because, assuming Sub A’s cash position is substantial and Parent uses those funds to finance Parent’s business the transaction in some ways looks more analogous to an equity investment than a dividend or return of capital.

### Unintended Consequences
- Sub A now owns part of Parent for State X purposes. In the event Sub A’s ownership interest is large enough, attribution rules could cause Sub A to own part of itself for State X tax purposes.
- Parent now has a different basis in the Stock of Sub B for State X, federal tax, and other states’ tax purposes
- In the event Parent desires to divest ownership of business, it could be confronted with large gain on sale for state tax purposes due to the lack of basis
- Could dilute ownership interest in Parent of other investors.
- Consequences for unitary or consolidated groups?

**Complicating Factors**
- What if the reclassified I/C debt is between Sub A and Sub B
- What if one or more of the Subs are disregarded SMLLCs
- What if Parent is a flow-through entity
- What if one or more of the Subs are Foreign Subs

- Solution One gets the court to an easy answer that allows it to uphold the denial of the interest deductions but Solution One creates considerable unintended consequences and requires similar items to be classified differently.
- Solution Two solves the classification issue and in many ways appears to be consistent but also leads to a potentially disastrous consequence of biblical proportions, a subsidiary owning its parent and ultimately itself, dogs and cats living together, mass hysteria!

**Meaningless key words that create uncertainty, risk or opportunity**
- “Sham”
- “Bona Fide” or “Not Bona Fide” anything
- “Substantial economic reality”
- “Substantial economic risk”
- “Legitimate” or “Not legitimate” anything

**Take-away**
- Tax administrators and courts should be carefully consider whether it is appropriate to assert the Economic Substance Doctrine, and use it only as a last resort when no other tool is available and only in circumstances when it applies. Asserting the Economic Substance Doctrine improperly (or sloppy drafting in opinions) can result in severe and bizarre tax and non-tax consequences for both the state and the taxpayer.