February 24, 2010

Texas and Many Other States Will No Longer Automatically Respect the Form of Transactions Selected by Taxpayers for Sales Tax Purposes

Historically, a significant number of states had a general policy of respecting the form of a transaction chosen by a taxpayer and applied their sales tax laws based on that form of transaction. But several states, including Texas, that adopted and followed this policy are now undergoing a major shift to a new policy whereby they will determine the taxability of a transaction by viewing it two different ways—first, by looking at the transaction according to its form, and second, if the chosen form arguably lacks economic substance, by viewing the transaction based on its economic substance and possibly disregarding the form of transaction or exemption sought by the taxpayer.

The economic substance doctrine has its roots in federal tax law, but it is not commonly referenced or applied for state sales tax purposes. However, the reason for the Texas Comptroller's and other states' recent change of approach is simple—to increase tax revenues.

The Background in Texas

Under the Texas Comptroller's longstanding policy of respecting the form of a transaction, a taxpayer generally had the ability to plan and dictate a transaction's sales tax consequences by choosing a particular form of transaction. However, within the last 12 months, the Comptroller's office began signaling a policy shift by stating that it would begin reviewing the economic substance of certain types of transactions. On August 6, 2009, the Comptroller issued a ruling openly embracing the economic substance doctrine, and calling into question the historic form-over-substance framework which is an accepted principle of Texas sales tax jurisprudence.

The economic substance doctrine was created in federal tax law to prevent abusive and evasive transactions by allowing the IRS to look through the form of a transaction and recast it based on what it perceived as the economic realities of the transaction.

The August Ruling

The Comptroller's ruling in August 2009 (Policy Ruling No. 200908387L) is the first (and so far the only) time the Comptroller's office has used the phrase "economic substance" to look through the form of a transaction for sales tax purposes. The ruling addressed two hypothetical aircraft transactions. In the first hypothetical, an individual purchased an aircraft outside of Texas and attempted to make a tax-free contribution to his wholly-owned corporation before the aircraft entered Texas. In the second hypothetical, a broker sold an aircraft to one individual outside of Texas, who sold the aircraft to a second individual. The individuals attempted to claim that the sale from one individual to the other individual was an "occasional sale" exempt from sales tax.

The Comptroller did not expressly recast either transaction. Rather, the ruling merely describes the framework within which the Comptroller will analyze transactions. For example, the ruling provides that the Comptroller may recast an intercompany transaction that does not generate an "adequate return on capital." Additionally, the Comptroller lists several questions addressing various factors to be considered, including whether a series of transactions is preplanned or has substantial economic effect, whether there is economic risk or a business purpose to the transaction (or series of transactions), and whether the parties are related.

The Future Impact in Texas and Beyond

Taxpayers in Texas should consider the August ruling as a warning sign. Although the facts of the August ruling relate specifically to the sales tax consequences of an intercompany aircraft transaction and a situation in which a taxpayer sought an "occasional sale" exemption, taxpayers should act with the expectation that the Comptroller will fully extend the ruling's framework to other industries, exemptions, and taxes to the extent the economic substance doctrine does not already exist. Specifically, it appears that the Comptroller's office will apply the doctrine to any transaction or tax planning technique in which there is no profitability or valid business reason for the transaction or structure.

Moreover, taxpayers in other states also should heed this warning because states are increasingly looking to the economic substance doctrine as a way to generate additional revenue by recasting in a taxable light transactions that taxpayers have claimed to be nontaxable. What is not clear at this point is whether and to what extent courts will agree with and adopt the approach put forth by the Texas Comptroller and other state taxing authorities regarding substance of transactions controlling instead of their form.

If you have any questions about the August ruling, please contact the Haynes and Boone, LLP Tax Practice Group or one of the attorneys identified below.

Kenneth K. Bezozo
212.659.4999
kenneth.bezozo@haynesboone.com

Jeff W. Dorrill
214.651.5781
jeff.dorrill@haynesboone.com

Brandon S. Jones
817.347.6626
brandon.jones@haynesboone.com

Jeffrey M. Slade
214.651.5899
jeff.slade@haynesboone.com

In order to comply with certain U.S. Treasury regulations, we are informing you that any U.S. federal tax advice that may be contained in this document is not intended or written to be used, and cannot be used, by any person for the purpose of (i) avoiding any tax penalties that may be imposed by the Internal Revenue Service or any other U.S. federal taxing authority or agency or (ii) promoting, marketing, or recommending to another party any transaction or matter addressed herein.