OREGON
DEPARTMENT
OF REVENUE

# Legislative Testimony

**House Committee on Revenue** **February 23, 2015**

## HB 2103 Economic Substance


**Summary**

HB 2103 codifies the "economic substance doctrine" under Oregon law. The bill specifies that in cases where the Department disputes the economic substance of a transaction, the taxpayer must establish that (1) the transaction had economic substance beyond tax benefits and (2) the taxpayer had a nontax business purpose for entering into the transaction.


The following information is provided in response to questions raised during the February 23, 2015 House Revenue Committee hearing regarding HB 2103:

1) **If the economic substance doctrine is not codified under Oregon law, would the common law principle of economic substance still apply?**

Under the common law economic substance doctrine, a transaction will not be respected for tax purposes if the transaction lacks a legitimate business purpose other than to achieve a tax benefit ("business purpose test") and/or if the transaction lacks economic substance ("economic substance test").

Some courts view this as a *disjunctive* test requiring either a business purpose or economic substance; other courts view this as a *conjunctive* test requiring both a business purpose and economic substance.

In 2010, the U.S. Congress codified the economic substance doctrine under IRC Section 7701 and clarified that for federal tax purposes, the test is conjunctive. That is, a taxpayer must be able to demonstrate that a disputed transaction has a legitimate business purpose other than a tax benefit, and also that the transaction provides some economic benefit to the taxpayer other than a reduction in tax.

If the economic substance doctrine is not codified under Oregon law, it is unclear whether the courts would apply the disjunctive test or the conjunctive test.

2) **Please provide examples of disputed transactions where the economic substance doctrine might be applied.**

### Corporate Tax Program

**Example:** BigStore is a large multistate retail corporation that sells furniture to customers in all 50 states, including Oregon. BigStore reports $100M annual sales revenue, and $4M of that revenue is attributable to its retail outlets in Oregon. BigStore also provides consumer credit to its customers, and reports $100M in annual interest income on its accounts receivables. The Oregon corporate tax return reports that $4M of the interest income is attributable to Oregon customer accounts.

In 2014, BigStore transferred all of its accounts receivable to a subsidiary (BigStore Asset Management Corp) incorporated in the state of Delaware. While BigStore (the parent corporation) maintains operations within Oregon and has taxable nexus in this state, BigStore Asset Management has no offices or employees, and aside from the accounts receivables originally generated in Oregon, it has no actual connection to our state or to any other state. The state of Delaware imposes no income tax on the interest income attributable to BigStore's accounts receivables.

BigStore files a consolidated Oregon corporation tax return. Both the parent company and the asset management company are included in that return. However, because BigStore Asset Management has no nexus within Oregon, the interest income attributable to Oregon consumer loans is excluded from the sales factor numerator for purposes of apportionment. The Oregon tax effect is shown below.

**Prior to the transfer of BigStore accounts receivable to BigStore Asset Management:**

| | | | |
|---|---|---|---|
| Oregon retail sales = | $4M | Total retail sales everywhere = | $100M |
| Oregon interest income = | $4M | Total interest income everywhere = | $100M |
| Total Oregon receipts = | $8M | Total receipts everywhere = | $200M |

Based on the above, the Oregon apportionment percentage is 4% (8M / 200M). That is, 4% of the corporation's federal taxable income (with OR modifications) is subject to tax in this state.

**After the transfer of BigStore accounts receivable to BigStore Asset Management:**

| | | | |
|---|---|---|---|
| Oregon retail sales = | $4M | Total retail sales everywhere = | $100M |
| Oregon interest income = | 0 | Total interest income everywhere = | $100M |
| Total Oregon receipts = | $4M | Total receipts everywhere = | $200M |

Based on the above, the Oregon apportionment percentage is 2% (4M / 200M). That is, 2% of the corporation's federal taxable income (with OR modifications) is subject to tax in this state.

The transfer of BigStore's accounts receivables to BigStore Asset Management had no real economic effect on the corporation other than tax benefits. Consumer loan payments are still processed in the same manner as before the paper transfer of the accounts. There was no change in business operations, and no change in the corporation's profit and loss statements. BigStore's federal taxable income is also unchanged. However, BigStore's Oregon apportionment percentage has been effectively cut in half, and the corporation's tax liability in Oregon will be reduced by half.

Under the economic substance doctrine, the department could assert that this transaction (the transfer of accounts receivable to BigStore Asset Management) lacked economic substance because there was:

(a) no business purpose other than tax avoidance; and (b) there was no economic benefit obtained by the corporation other than tax reduction. This is a typical "substance over form" argument.

In the absence of codification of the economic substance doctrine that clearly establishes a two-part conjunctive test, it may not be necessary for the taxpayer to demonstrate any actual economic benefit from this transaction beyond tax reduction – a purported alternate business purpose might be sufficient to satisfy the common law test.

## Personal Income Tax Program

**Example:** David is the sole shareholder of two S-Corporations and he resides in the state of Washington. One S-Corporation (A) is located in Oregon and does business entirely inside this state. The other S-Corporation (B) is located and does business entirely inside Washington. S-Corporation A has a patent worth $500,000 that they are planning to sell. Prior to the sale, S-Corporation A transfers ownership of the patent on its accounting books to S-Corporation B. After the ownership transfer, Corporation B sells the patent and does does not report the sale of the asset to Oregon because it is Washington property.

Under the economic substance doctrine, the department could assert that the transfer of the patent is not allowable for tax purposes because the transfer of the asset lacked a business purpose other than tax avoidance, and there was no economic benefit other than a reduction of tax. The department would require the sale to be reported on the Oregon tax return filed by S-Corporation A. The resulting income from the sale of the patent would flow through to David's individual Oregon non-resident return.

**For more information about this testimony, contact Joe DiNicola at 503-945-8308.**