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Subject: The Importance of Business Purpose and Economic Substance
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To: Our Clients and Friends

State and local taxing jurisdictions continue to focus on business purpose and economic substance when analyzing taxpayer transactions or structures. These concepts may be invoked to question a transaction or structure if: (1) the entities involved serve no business purpose other than tax avoidance; (2) the transaction or structure is not bona fide; (3) the entities involved do not maintain separate identities and ignore corporate formalities; and/or (4) one entity to the transaction or structure controls the other entity.

The concepts of business purpose and economic substance are generally utilized by states to override the literal reading of a statute or regulation that produces a result that is deemed unfair or inappropriate. These concepts often come into play when challenges to the deductibility of expenses or the allowance of other tax benefits in connection with tax-motivated transactions or structures occur.

A few states have even passed legislation specifically authorizing a business purpose/economic substance analysis to taxpayer transactions or structures. For example, in Massachusetts, the commissioner may disallow the tax consequences of a transaction by applying the sham transaction doctrine or any other related doctrine. If the Massachusetts commissioner exercises this authority, the taxpayer must demonstrate that: (1) the transaction has a valid, good faith business purpose other than tax avoidance; (2) the transaction has economic substance apart from the asserted tax benefit; and (3) the asserted nontax business purpose is commensurate with the tax benefit claimed.

A recent opinion addressing the issues of business purpose and economic substance was released in Indiana (Indiana Dept. of State Rev. Letter of Finding No. 03-0112, January 1, 2006). If you are interested in obtaining a copy of this opinion, or would like to further review the within concepts as they may apply to your company, please do not hesitate to contact me.

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