Florida State University College of Law

Scholarship Repository

Scholarly Publications

10-27-2008

Substance and Form in State Taxation

Steve R. Johnson
Florida State University College of Law

Follow this and additional works at: https://ir.law.fsu.edu/articles

Part of the Taxation-State and Local Commons, and the Tax Law Commons

Recommended Citation
Steve R. Johnson, *Substance and Form in State Taxation*, 50 *ST. TAX NOTES* 239 (2008),
Available at: https://ir.law.fsu.edu/articles/317

This Article is brought to you for free and open access by Scholarship Repository. It has been accepted for inclusion in Scholarly Publications by an authorized administrator of Scholarship Repository. For more information, please contact efarrell@law.fsu.edu.

Substance and Form in State Taxation

by Steve R. Johnson

In the interpretation of tax statutes, a venerable principle is that "taxation should move in an atmosphere of practical realities rather than amid the intricate and wooden concepts" of legal formalities.[1] That principle is familiar in federal taxation, and it holds no less sway in state and local taxation.[2] Indeed, the idea that the substance of a transaction usually controls over the form of the transaction is not confined to taxation; it is a principle of U.S. law generally.

The principle commands that the underlying reality of the events usually determines tax consequence; the forms or labels attached to the events by the parties themselves (by contract or otherwise), or even by nontax law usually, are not determinative.[3] This column will explore the "substance versus form" rule from three perspectives: justification for the rule, the reach of the rule and examples of its application in state and local taxation, and use of the rule in favor of taxpayers.

[1]*Kohn v. Commissioner*, 197 F.2d 480, 482 (2d Cir. 1952) (*quoting* Randolph E. Paul, "The Effect on Federal Taxation of Local Rules of Property," in *Selected Studies in Federal Taxation* 1, 21 (2d Ser. 1938)).

[2]*E.g.*, *Commissioner v. Sunnen*, 333 U.S. 591, 604-605 (1948); *Corliss v. Bowers*, 281 U.S. 376, 378 (1930) (Holmes, J., writing for a unanimous Court); *Stratton-Cheeseman Management Co. v. Department of Treasury*, 159 Mich. App. 719, 725, 407 N.W.2d 398 (1987); *Scotchman's Coin Shop, Inc. v. Administrative Hearing Comm'n*, 654 S.W.2d 873, 875 (Mo. 1983) (*en banc*).

[3]*E.g.*, *Metropolitan Life Ins. Co. v. State Bd. of Equalization*, 32 Cal. 3d 649, 656-657 (1982) (private party's label disregarded); *Tyler v. United States*, 281 U.S. 497, 503 (1930) (nontax law label disregarded); *see also* Steve R. Johnson, "Fog, Fairness, and the Federal Fisc: Tenancy-by-the-Entireties Interests and the Federal Tax Lien," 60 *Mo. L. Rev.* 839, 858-860 (1995).

Justification

In some instances, state statutes confer on the revenue authority the power to assert tax deficiencies when the reality of what the taxpayer did differs from the form in which the transactions were cast. For example, the Oregon courts have located that power in a state statute that was modeled on section 482 of the Internal Revenue Code.[4]

> ***Although the substance-over-form rule sweeps broadly, there are many times when form still does control in the tax law.***

Far more commonly, however, the courts cite only other cases as their authorities for applying substance over form. The judge's theory of statutory construction bears on the legitimacy of applying substance over form without explicit statutory authorization. Many state judges espouse one or another variation of purposivism or intentionalism as the touchstone of interpreting tax statutes. For them, substance-based interpretation is natural because the legislature will rarely have intended to accord tax benefits to mere shell entities or "in name only" transactions. As one court put it:

> Tax legislation should be implemented in a manner that gives effect to the economic substance of the transaction and the taxing authority may not be required to acquiesce in the taxpayer's election of a form . . . but rather may look to the reality of the tax event and sustain or disregard the effect of the fiction in order to best serve the purposes of the tax statute.[5]

[4]*Pacificare Health Systems, Inc. v. Department of Revenue*, 2008 WL 2596371, at *4 (Or. Tax Magistrate Div. 2008) (applying Or. Rev. Stat. 314.295).

[5]*Guttman Picture Frame Assoc. v. O'Cleireacain*, 618 N.Y.S.2d 781, 781-782 (App. Div. 1994); *see also Gregory v. Helvering*, 293 U.S. 465, 469-470 (1935).

Although preferring substance to form is, as we have seen, natural for judges inclined to purposive or intentionalist approaches to statutory interpretation, judges of textualist persuasion typically also advert to substance over form. Textualism cannot fairly be reduced to the myopic literalism of looking only at statutory language in isolation. Essential to contemporary textualism is putting the text in context, fitting the statute at hand into the fabric of the existing law. Thus, textualists can and do apply the substance-over-form approach because it is abundantly precedented, which creates an acceptable external context into which the statute at hand is to be fit.[6]

Reach of the Rule

The substance-over-form rule cuts a wide swath in state and local taxation. For example, the rule has been applied by courts to state tax controversies involving the following:

- whether a particular transaction constituted a conditional sale agreement or a lease for income tax purposes;[7]
- allocating lump sum payments among categories for income tax and franchise tax purposes;[8]
- who had an economic interest in coal for severance tax purposes;[9]
- who was providing insurance for gross premiums tax purposes;[10]
- characterization of rent versus other types of payments for income tax purposes;[11]
- apportionment of income and deductions regarding licenses of intangible property for income tax purposes;[12] and
- whether diversion of natural gas from a pipeline as fuel for compressor engines is a purchase for use tax purposes.[13]

The rule's most frequent application is in the preassessment phase — that is, at the stage of determining the amount of the taxpayer's tax liability. However, the rule is sometimes also applied postassessment, at the stage of using the mechanisms for collecting determined liabilities and the remedies against those mechanisms available to taxpayers and third parties.[14]

The rule generally is invoked in civil tax matters. However, on rare occasion, it is also applied in state criminal tax cases. For example, in a Tennessee case, the state Department of Revenue discovered that a taxpayer was holding himself out as a dealer in gold and silver bullion, coins, and precious metals but was not registered with the DOR for sales tax purposes, was not filing sales tax returns, and was not remitting sales tax. In an undercover operation, a revenue agent posing as a buyer asked the taxpayer about sales tax. The taxpayer replied that the transactions were nontaxable because the taxpayer actually was buying customers' federal reserve notes and paying for them in precious metals. The taxpayer was convicted on two criminal counts for delaying and depriving the state of its lawful revenue. On appeal, the court rejected the taxpayer's fanciful construction of the sales transactions and the logomachy on which it was based. In doing so, the appellate court remarked that it was necessary to "look beyond the contested, varying surface meanings of terms such as 'money,' 'legal tender,' and 'medium of exchange.' Instead we must delve into the substance, particularly the economic substance, of the transactions at issue."[15]

---

[6]The leading textualist on the current scene has remarked that "the good textualist is not a literalist" and that "in textual interpretation, context is everything." Antonin Scalia, "Common-Law Courts in a Civil-Law System: The Role of United States Federal Courts in Interpreting the Constitution and Laws," in *A Matter of Interpretation: Federal Courts and the Law* 24, 37 (1997); *see also Green v. Bock Laundry Mach. Co.*, 490 U.S. 504, 528 (1989) (Scalia, A., concurring in the judgment) (stating that statutes should be read "on the basis of which meaning is (1) most in accord with context and ordinary usage . . . and (2) most compatible with the surrounding body of law into which the provision must be integrated").

[7]*AD&R Inc. v. Department of Revenue*, 2007 WL 900761, at *5-7 (Or. Tax Magistrate Div. 2007). For exploration of similar issues at the federal level, see *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978); *Hilton v. Commissioner*, 74 T.C. 305 (1980), *aff'd*, 671 F.2d 316 (9th Cir. 1982); *Lieber v. Commissioner*, T.C. Memo. 1993-391.

[8]*Mourad Bros., Inc. v. Department of Treasury*, 431 N.W.2d 98 (Mich. App. 1988); *Schwartz v. Wisconsin Dep't of Revenue*, 653 N.W.2d 150, 157-159 (Wis. App. 2002).

[9]*Vericoals, Inc. v. Revenue Cabinet*, 869 S.W.2d 49 (Ky. App. 1994).

[10]*Metropolitan Life Ins.*, *supra* note 3, 32 Cal. 3d at 656-657; *Lincoln Nat. Life Ins. Co. v. Board of Equalization*, 36 Cal. Rptr. 2d 397, 399-403 (Cal. App. 1994); *Prudential Ins. Co. v. State Board of Equalization*, 26 Cal. Rptr. 2d 287 (Cal. App. 1993).

[11]*Radford v. Department of Revenue*, 2007 WL 3130558 (Or. Tax Magistrate Div. 2007); *cf. O'Brien v. Department of Revenue*, 2008 WL 2404031 (Or. Tax Magistrate Div. 2008) (similar characterization regarding claim for elderly rental assistance).

[12]*Pacificare Health Systems, Inc. v. Department of Revenue*, 2008 WL 2596371 (Or. Tax Magistrate Div. 2008).

[13]*Great Lakes Gas Transmission L.P. v. Commissioner of Revenue*, 638 N.W.2d 435, 437-439 (Minn. 2002).

[14]*E.g., Pitti v. Pocono Bus. Furniture, Inc.*, 859 A.2d 523, 526-528 (Pa. Commonw. Ct. 2004) (applying the rule in the context of a quiet title action brought by the purchaser of forfeited property at a private tax sale).

[15]*State v. Sanders*, 1994 WL 413465, at *6 (Tenn. Crim. App. 1994) (unpublished op.) (applying T.C.A. section 67-1-1440(d)), *aff'd*, 923 S.W.2d 540 (1996), *denial of habeas corpus aff'd*, 221 F.3d 846 (6th Cir. 2000), *cert. denied*, 531 U.S. 1014 (2000).

Although the substance-over-form rule sweeps broadly, it is not all-conquering. There are many times when form still does control in the tax law. For example, the realization doctrine — the rule that gains are not taxable and losses are not deductible until the occurrence of an event such as sale, exchange, or abandonment — is a major form-driven aspect of income taxation.[16] Accordingly, the accurate statement is that substance controls over form in tax law except when it doesn't. Put more helpfully, one should expect substance to prevail unless there is a clear and settled tradition in an area that makes form controlling.

Use of the Rule by Taxpayers

The substance-over-form rule usually is applied in favor of the revenue authority. The taxpayer was a party to the transaction at issue and so had a hand in choosing the form in which the transaction was cast. Thus, although there is a split of authority, some courts refuse to allow taxpayers to assert that the substance of their transaction was different from its form.[17] In some cases, however, state courts have applied the substance-over-form approach favorably to the taxpayer.[18]

> ***One should expect substance to prevail unless there is a clear and settled tradition in an area that makes form controlling.***

An example is an Illinois use tax case. Illinois law provided that the use tax does not apply to tangible personal property purchased in an "isolated or occasional sale [from] a person who does not hold himself out as being engaged (or who does not habitually engage) in selling such tangible personal property."[19] Simplifying the complicated facts, the taxpayer bought a corporate jet airplane owned by Richland Development Corp. Richland represented (apparently accurately) that it was not a retailer, that its sale of the airplane was an isolated or occasional sale, and that it was not engaged in the business of selling airplanes at retail. However, the transfer of title did not occur directly between the taxpayer and Richland. Instead, Richland transferred title to the airplane to Nationsbanc Leasing Corp., which then transferred title to the airplane to the taxpayer. Unlike Richland, Nationsbanc was a retailer of airplanes.

> ***In some courts and under some circumstances, the substance-over-form principle is available to taxpayers as well as to the revenue authority.***

After acquiring the airplane, the taxpayer used it in Illinois. The taxpayer, relying on the "isolated purchase from a nonretailer" exception, did not pay use tax to Illinois for the airplane. The Illinois Department of Revenue disagreed. Noting that the taxpayer got the airplane from a retailer (Nationsbanc), the DOR concluded that the exception did not apply, and the DOR issued a notice of liability, proposing an assessment of use tax, interest, and a late filing penalty. In the ensuing litigation, the trial court held for the taxpayer and the appellate court affirmed.[20]

The taxpayer argued substance over form. The taxpayer acknowledged that, in form, it had received title to the airplane from Nationsbanc. But the taxpayer maintained that, in substance, it had bought the plane from Richland and that Nationsbanc had been used only as a conduit. The DOR rejoined that a "taxpayer does not have the right to assert that the substance of the transaction, rather than the form, should prevail."[21]

The appellate court cited the division of the precedents as to whether the substance-over-form gate swings only one way (that is, can be asserted only by

---

[16]*See, e.g., Cottage Sav. Ass'n v. Commissioner*, 499 U.S. 554, 559 (1991) (noting that the realization doctrine looks to changes in form to further administrative convenience).

[17]*See, e.g., Commissioner v. National Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134, 149 (1974) (observing that taxpayers generally may not disavow the form of their own deals); *Guttman Picture Frame Assoc., supra* note 5, 618 N.Y.S.2d at 782 (saying that the fiction of the form of the transaction may nonetheless be sustained if doing so would advance the purposes of the tax statute). *But see, e.g., Comdisco, Inc. v. United States*, 756 F.2d 569, 577-578 (7th Cir. 1985); *Weinert's Estate v. Commissioner*, 294 F.2d 750, 755 (5th Cir. 1961) (both allowing the taxpayer to assert substance in conflict with the chosen form, under some circumstances).

[18]*E.g., Bulkmatic Transp. Co. v. Department of State Revenue*, 715 N.E.2d 26, 35 (Ind. Tax Ct. 1999) (rejecting a distinction offered by the revenue authority because "'formal distinctions that lack economic substance' are irrelevant in analyzing state tax under the Commerce Clause") (quoting *Westinghouse Elec. Corp. v. Tully*, 466 U.S. 388, 405 (1984)).

[19]Use Tax Act section 3-65, 35 I.L.C.S. 105/3-65 (West 1994), and Retailers' Occupation Tax Act section 1, 35 I.L.C.S. 120/1 (West 1994).

[20]*JI Aviation, Inc. v. Department of Revenue*, 781 N.E.2d 469 (Ill. App. 2002).

[21]*Id.* at 473.

the government) or both ways (that is, can be asserted by taxpayers as well as by the government).[22] Relying on both state and federal cases, the court concluded that there is no absolute bar against the taxpayer arguing that the form of the transaction does not reflect its substance.[23] Looking at the substance, the court said that:

- written agreements defined a limited role for the conduit in the transaction;
- the conduit immediately reconveyed title;
- the conduit assumed no liability for good title;
- the conduit reconveyed the purchase price and retained no part of it; and
- the conduit paid no closing costs.

On those grounds, the court concluded that, in substance, the purchase was from Richland and that therefore the "isolated purchase from a nonretailer" exception shielded the taxpayer from use tax liability.[24]

Conclusion

The substance-over-form rule is a powerful interpretational principle. It has been applied widely in state and local tax litigation. At least in some courts and under some circumstances, the principle is available to taxpayers as well as to the revenue authority. ☆

Interpretation Matters is a column by Steve R. Johnson, the E.L. Wiegand professor and associate dean for Faculty Development and Research, William S. Boyd School of Law, University of Nevada, Las Vegas. He can be contacted at steve.johnson@unlv.edu.

[22]For further discussion of this issue, see William S. Blatt, "Lost on a One-Way Street: The Taxpayer's Ability to Disavow Form," 70 *Or. L. Rev.* 381 (1991).

[23]781 N.E.2d at 478-481 (*citing In re Stoecker*, 179 F.3d 546 (7th Cir. 1999), and *Weber-Stephen Prods., Inc. v. Department of Revenue*, 756 N.E.2d 321 (Ill. App. 2001)).

[24]781 N.E.2d at 481-484.