# What Level of Tax Avoidance Is Acceptable?

*by Brian Strahle*

Here's a multiple choice: the difference between tax avoidance and tax evasion is (a) whatever the IRS says, (b) a smart lawyer, (c) 10 years in prison, (d) all of the above.

— Avery Tolar (Gene Hackman) in *The* Firm

According to the courts, tax avoidance is legal, but tax evasion is not. However, tax avoidance without business purpose or economic substance may be treated as a sham and disallowed. The history of state tax planning and two recent conflicting state decisions raise a question: What level of tax avoidance is acceptable?

Senate Finance Committee member Chuck Grassley, R-Iowa, once said that at the heart of every abusive tax shelter is a tax lawyer or accountant. That may be true, but what about legal tax planning and avoidance? Who, or what, is at the heart of tax avoidance? The answer to that may depend on the experience of the individual responding — whether he has worked for the government or has represented taxpayers against the government. Hence, we all decide whether tax avoidance should be allowed based on our own biases. For example, I have always worked as a taxpayer representative or advocate. Thus, I naturally lean toward the taxpayer's point of view.

From the taxpayer's side, I have experienced tax authorities abuse power, neglect the law, and use vague laws to raise revenue. States have imposed unconstitutional state taxes and pleaded bankruptcy when found guilty. On the other side, I have experienced taxpayers and advisers who analyze laws to the finite detail to wiggle around corners and yet stay within the boundaries of the law. As a result, both government and taxpayers can take advantage of the law, but who is right? What is acceptable? What came first — aggressive tax planning or overreaching and vague tax laws?

**The Tug of War**

In 2009 Charles Barnwell Jr. outlined the history and possible future of state tax planning and provided an informative, panoramic view of the tug of war between state tax planners and taxing authorities.[1] He described the 1980s as a period of "blocking and tackling," with state tax planners learning to create nowhere income using P.L. 86-272 and using origination shipment in states without throwback rules. Over time those strategies lost strength as states began "chipping at the edges of 'solicitation' to narrow the applicability of P.L. 86-272," according to Barnwell.

Barnwell said taxpayers began developing one-off planning strategies such as the infamous Delaware intangible holding company in the late 1980s. Taxpayers began placing debt and isolating various nexus-creating activities in separate entities and domestic tax havens like Nevada. States fought back using IRC section 482 and economic nexus challenges, as well as combination.

The next generation of tax planning involved comprehensive, process-driven projects to minimize state taxation, Barnwell wrote. Those strategies included base shifting away from separate-filing states, as well as East/West splits, which used "the unitary-state-dominated western United States as the 'income concentration point,'" Barnwell said. He described how taxpayers have continued to create structures and analyze laws to reduce state tax burdens while states continue to look for ways to minimize tax revenue losses.

In 2007 some of the state tax planning strategies became mainstream, with *The Wall Street Journal* laying bare Wal-Mart's story.[2] The article described various state tax reduction strategies Wal-Mart implemented such as taking tax deductions in California for dividends it never actually paid or using a limited partnership structure to avoid the Texas franchise tax. According to the article, company e-mails and memos produced in the North Carolina

[1]Barnwell, "State Tax Planning — What's Left?" *State Tax Notes*, Dec. 21, 2009, p. 857.

[2]Jesse Drucker, "Inside Wal-Mart's Bid to Slash State Taxes," *The Wall Street Journal*, Oct. 23, 2007.

state court case against Wal-Mart showed that the transactions' primary purpose was minimizing state income taxes. The tax savings were not simply byproducts of transactions entered into for other business reasons, as companies claim.

The accounting firm involved in the Wal-Mart planning delivered a 37-page proposal outlining 27 potential tax strategies. Some were cookie-cutter strategies and some were very aggressive with considerable risk. Court records showed that Wal-Mart had switched state income tax strategies several times over 15 years in order to use new approaches as the states attacked existing ones. The new approaches were described as domestic restructuring projects, not tax minimization projects.

Regardless of how tax avoidance is labeled or whether it has economic substance or a business purpose, it can be treated as a tax shelter or sham transaction.

### Indiana Says No Substance, No Service

The Indiana Department of Revenue recently upheld a sales and use tax assessment on two vehicles after finding the taxpayers' claim that their Montana limited liability company purchased the vehicles to be a sham transaction, with the LLC established for the sole purpose of purchasing the vehicles tax free.

In the decision, the taxpayers freely admitted that the vehicles were used in Indiana, but were actually purchased by the Montana LLC, which the taxpayers managed. A Montana services company, which publicly invites customers to incorporate in tax-free Montana to save thousands on sales taxes, assisted the taxpayers in establishing their LLC.

Other than the purchase of the vehicles, the taxpayers were unable to provide evidence establishing any business or nonbusiness activity by the LLC in Indiana, Montana, or any other state. While the LLC made no attempt to undertake any further activity, the titling of the vehicles by the LLC did have an effect on the taxpayers' sales and use tax responsibility. According to the DOR, a "tax avoidance effect" leads to consideration of the sham transaction doctrine, which dates back to *Gregory v. Helvering*. To qualify for favorable tax treatment, a corporate reorganization must be motivated by a legitimate corporate business purpose. A corporate business activity undertaken merely to avoid taxes lacks substance, and "to hold otherwise would be to exalt artifice above reality," the Court said in that case.

In *Horn v. Commissioner*, 968 F.2d 1229, 1236 (D.C. Cir. 1992), the court said, "Transactions that are invalidated by the sham transaction doctrine are those motivated by nothing other than the taxpayer's desire to secure the attached tax benefit, and are devoid of any economic substance." In determining whether a business transaction is an economic sham, two factors can be considered: did the transaction have a reasonable prospect for economic gain (profit) and was the transaction undertaken for a business purpose other than the tax benefits? For purposes of the doctrine, the question whether a transaction is a sham is primarily a factual one.[3]

In the Indiana decision, the Montana LLC had no business or nonbusiness functions and never attempted to acquire, maintain, or dispose of any property other than the vehicles. According to the DOR, the titling of the vehicles in Montana, a state without a sales tax, was an apparent attempt to reduce or eliminate the taxpayers' sales and use tax liabilities. The formation of the LLC and the titling of the vehicles in the name of the LLC therefore constituted a sham transaction.

### Louisiana Says No Substance, No Problem

In a similar case, a Louisiana resident formed a single-member LLC in Montana and used the LLC to purchase a recreational vehicle. Montana issued a certificate of title for the RV in the name of the LLC. The Louisiana DOR issued a notice of proposed tax due asserting that the resident owed the sales tax on the RV. The resident filed a petition of review with the Board of Tax Appeals claiming he did not personally owe any sales tax to Louisiana. The board ruled against him and he appealed to the district court, which reversed the board's decision. The DOR appealed, but the First Circuit Court of Appeal agreed with the district court and ruled for the taxpayer.[4]

According to the appellate court, the DOR claimed that the taxpayer committed fraud in setting up an LLC in Montana for the sole purpose of avoiding Louisiana sales tax. The court ruled there was no evidence in the record that the taxpayer committed fraud. The court said the Montana State Legislature must have known when it enacted the law that it could create opportunities for taxpayers to avoid tax; thus, the fact that a taxpayer took advantage of the law — or simply complied with the law by structuring its transaction in the most tax-efficient manner — does not make the transaction illegal or a sham. It noted that *Black's Law Dictionary* defines tax avoidance as "the act of taking advantage of legally available tax-planning opportunities in order to minimize one's tax liability" and tax evasion as "the willful attempt to defeat or circumvent the tax law in order to illegally reduce one's tax liability."

The court also found that the record failed to establish that the taxpayer was the LLC's alter ego

[3]*Lee v. Commissioner*, 155 F.3d 584, 586 (2d Cir. 1998).

[4]*Thomas v. Bridges*, No. 2012 CA 1439 (La. Ct. App. 1 2013).

such that the entity's veil should be pierced. Some of the factors courts consider when determining whether to apply the alter ego doctrine include commingling of corporate and shareholder funds, failure to follow statutory formalities for incorporating and transacting corporate affairs, undercapitalization, failure to provide separate bank accounts and bookkeeping records, and failure to hold regular shareholder and director meetings.

The record also reflected that the vehicle was being housed in Mississippi. Nothing in the record suggested that the vehicle was being housed or used in Louisiana, requiring any other tax to be owed.

### Multistate Tax Commission Gets Involved

The Multistate Tax Commission filed an amicus brief urging the Louisiana Supreme Court to grant certiorari, arguing that allowing the use of shell LLCs for the sole purpose of purchasing and registering motor vehicles in another state would encourage tax avoidance.[5] The MTC pointed out that the taxpayer admitted that the LLC had no employees and no intended or planned business function or purpose other than holding title to the motor home to avoid sales tax obligations in the owner's state of residence.

The MTC said the lower court failed to acknowledge the role of the sham or economic substance doctrine and that its decision encourages taxpayer noncompliance with legislative intent. The MTC referred to *Gregory v. Helvering*, saying it supports the conclusion that transactions can meet the letter of the law and yet be disallowed because they defeat the legislative purpose behind the law.

According to the MTC, possibly the most concerning conclusion reached by the appellate court is that the Louisiana Legislature must have intended that LLCs could be used as a mechanism for allowing taxpayers to avoid their obligations under the law because it recognizes the separate legal status of domestic and foreign LLCs. The MTC argued that if the decision is allowed to stand, it "would create a dangerous precedent that would only encourage other taxpayers to engage in 'elaborate and devious forms of conveyance' to avoid their tax obligations."

### Conclusion

The tug of war between governments enacting loophole-eliminating legislation and taxpayers implementing tax minimization strategies appears to be never-ending. Tax avoidance is legal, but states like Indiana may disallow a transaction if it lacks economic substance and business purpose. However, the Louisiana decision creates tension by looking at the legislation as the problem, not the taxpayer. ✰

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[5]MTC amicus curiae brief in support of defendant's application for writs of certiorari (Oct. 10, 2013) LINK.