ECONOMIC SUBSTANCE: VIEWS FROM THE U.S., EUROPE, AND THE B.V.I., CAYMAN, AND NEVIS

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Sham Transaction

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Like concepts of beauty, the presence or absence of economic substance in the tax context often is in the eye of the beholder. As importantly, economic substance means different things to tax authorities in different jurisdictions. This article looks at the concept of economic substance in three separate localities – the U.S., the E.U., and certain Caribbean jurisdictions.

THE VIEW FROM THE U.S.

Background

U.S. tax law has a doctrine known as the economic substance doctrine. The main purpose is to prevent taxpayers from entering into artificial transactions for the principal reason of reducing tax exposure. Under the doctrine, a transaction that is purely or substantially tax motivated is disregarded.

The doctrine has been recognized in the caselaw for over 90 years. In 2020, it was codified in order to have the same standard applied in U.S. courts no matter where located. In comparison to rules in the E.U. and several Caribbean jurisdictions, it applies to transactions rather than the entities conducting transactions.

Along with the economic substance doctrine, caselaw has created other doctrines meant to achieve broadly the same effect. The various doctrines include the following:

- Economic substance doctrine
- Business purpose doctrine
- Sham transaction doctrine
- Substance over form doctrine
- Step transaction doctrine

However, the lines between these doctrines are not always clear. The result is that while these doctrines serve an important role in denying improperly earned tax benefits, it adds more uncertainty for taxpayers who may be caught by such doctrines. For example, the economic substance doctrine states that tax benefits can be denied if the transaction that gives rise to those benefits lacks economic substance independent of U.S. Federal income tax considerations, even if all facts occurred. Similarly, the business purpose doctrine states that tax benefits can be denied if the transaction was not intended to serve some useful non-tax purpose. Where both a useful non-tax purpose exists alongside overriding tax purposes, some courts have bifurcated the transaction in order to disallow the tax benefits of the overall transaction. Caselaw has not always helped in drawing clearer lines.