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Tax Court to Consider Relevancy Threshold for Economic Substance Doctrine Under Section 7701(o)

The Tax Court has invited amicus briefs and will address the codified meaning of the economic substance doctrine after increased IRS use of the doctrine to challenge taxpayer transactions.

Key Points:

- In 2010, Congress codified the economic substance doctrine in Section 7701(o)¹ of the Internal Revenue Code, but to date there is minimal caselaw interpreting it because the IRS formerly required executive approval before an examining agent could invoke it.
- Since 2022, the IRS has relaxed that policy, leading to more audits in which the IRS exam team asserts the economic substance doctrine and its associated strict liability penalties.
- A judge in the District of Colorado recently applied the doctrine without first conducting a relevancy determination. On July 19, 2024, the Tax Court requested briefs, including amicus briefs, on whether Section 7701(o) requires that threshold inquiry and set a briefing deadline for August 23, 2024.
- On August 22, 2024, the Court extended the time to file a motion for leave to file an amicus curiae to September 6, 2024. The parties' briefs continue to be due August 23, 2024.

In a July 19, 2024, [order](#) in *Patel v. Commissioner*,² the Tax Court requested briefs from the parties and amici curiae on whether Section 7701(o) of the Internal Revenue Code requires a threshold relevancy determination before applying the codified economic substance doctrine, and if so, the circumstance(s) in which the economic substance doctrine is "relevant" within the meaning of Section 7701(o). This is a novel question for the Tax Court.³ In an October 2023 ruling in the District of Colorado (on appeal to the US Court of Appeals for the Tenth Circuit), however, a federal district judge found that Section 7701(o) required no such determination. The Tax Court is thus signaling that it plans to address the relevancy argument and, if it accepts relevancy as a threshold requirement, the IRS could face a higher burden in applying the economic substance doctrine to recharacterize taxpayer transactions.

Patel involves an IRS determination that the petitioners' insurance premiums, paid to purported captive insurance companies, were not in fact insurance premiums for federal income tax purposes. Accordingly, the IRS denied the petitioners' deductions for those payments under Section 162. The Tax Court upheld this denial in a March 2024 order. The IRS also asserted penalties under Section 6662, including those attributable to a transaction allegedly lacking economic substance within the meaning of Section 7701(o).

The taxpayers argued that the codified rule first required a determination that the economic substance doctrine was relevant to their transaction, which the IRS did not address, triggering the Tax Court's request for additional briefing.

Section 7701(o) codified a longstanding judicial doctrine that courts have developed (with significant variability) since the seminal 1935 US Supreme Court decision in *Gregory v. Helvering*.⁴ The doctrine allows courts in certain circumstances to disregard a transaction that complies with the Code. Courts in different jurisdictions disagreed over the test to apply when evaluating economic substance. Still, the judicial consensus was that a court needed to inquire into whether, objectively, the transaction had a meaningful economic effect on the taxpayer (other than tax benefits) and whether, subjectively, there was a substantial non-tax business purpose for the transaction. A split among the circuits arose because some courts applied a conjunctive test in which a taxpayer needed to satisfy both prongs to demonstrate economic substance. Others applied a disjunctive test in which satisfying one prong would demonstrate economic substance, and still others applied a flexible test in which the two prongs were merely specific factors to consider in a court's analysis.

In codifying the doctrine in 2010 as a revenue-raising measure for healthcare reform, Congress mandated use of the conjunctive test. It also specified that when a taxpayer argues that a transaction is expected to generate profits, the present value of the reasonably expected pre-tax profit must be substantial in relation to the present value of the expected net tax benefits.

Congress included language in Section 7701(o) that required an analysis of economic substance only when "the economic substance doctrine is relevant." At the same time it provided that "[t]he determination of whether the economic substance doctrine is relevant to a transaction shall be made in the same manner as if this [law] had never been enacted." In explaining how Section 7701(o) was intended to apply, the House Report for the 2010 Act and the Joint Committee on Taxation provided a list of transactions in which the provision was intended *not* to apply, including the choice to use debt or equity, the choice to reorganize a corporation, and the choice to use a related party in a transaction.⁵

Some commentators believe that the statute may be unconstitutional because it is too vague.⁶ Others have suggested that codifying the doctrine, but declining to specify when the doctrine applies, raises due process concerns — particularly since Section 6662(b)(6) contains a strict liability penalty of 20% for underpayments of tax attributable to a lack of economic substance, which increases to 40% if the transaction is not disclosed.⁷

Since 2010, few cases have discussed Section 7701(o) because the IRS did not widely apply the codified economic substance doctrine and its associated penalties in the years following its enactment. The IRS had instituted a policy requiring executive approval before asserting economic substance penalties. That policy was relaxed in April 2022. We are now seeing these penalties asserted in more cases, including transfer pricing cases.

In a recent case in the District of Colorado, *Liberty Global, Inc. v. United States*,⁸ a federal district judge ruled that Section 7701(o) did not require a separate relevancy determination before applying the two-prong, conjunctive test. That case is currently on appeal to the Tenth Circuit in which Liberty Global and amici assert that Section 7701(o) *does* require a threshold relevancy determination.

Now, in *Patel*, which is appealable to the Fifth Circuit, the Tax Court has an opportunity to address the threshold relevancy issue and in what circumstance(s) the economic substance doctrine would be relevant to a transaction challenged under Section 7701(o). As the Tax Court noted, whether Section

7701(o) requires a threshold relevancy determination is a “novel[]” issue for the Tax Court.⁹ The Tax Court, however, has previously highlighted the “relevant” language in the statute,¹⁰ and some judges have acknowledged that the Code “warns [the Court] that it isn’t always relevant.”¹¹ Interested parties have until September 6, 2024, to file motions for leave and lodge amicus briefs to Judge Courtney Jones.

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Endnotes

¹ All references to “Section” are to the Internal Revenue Code of 1986, as amended (the Code).

² Nos. 24344-17, 11352-18, 25268-18 (U.S.T.C. July 19, 2024), ECF No. 366.

³ The Tax Court has not yet applied Section 7701(o) to a transaction.

⁴ 293 U.S. 465 (1935).

⁵ STAFF OF THE JOINT COMM. ON TAX’N, 111TH CONG., TECHNICAL EXPLANATION OF THE REVENUE PROVISIONS OF THE “RECONCILIATION ACT OF 2010,” AS AMENDED, IN COMBINATION WITH THE “PATIENT PROTECTION AND AFFORDABLE CARE ACT” (Comm. Print 2010); H.R. REP. NO. 111-443, pt. 1, at 291 (2010).

⁶ Thomas A. Cullinan & Shane A. Lord, *Economic Substance Doctrine: Unconstitutionally Vague?*, 130 *Tax Notes* 700 (2011), <https://taxprof.typepad.com/files/130tn0700.pdf>.

⁷ Amandeep S. Grewal, *When Is the Economic Substance Doctrine ‘Relevant’ to a Transaction?*, Univ. Iowa L. Stud. Rsch. Paper No. 2023-29 at 375-76 (Aug. 17, 2022), <https://ssrn.com/abstract=4193230>.

⁸ No. 1:20-cv-03501-RBJ (D. Colo. Oct. 31, 2023).

⁹ Nos. 24344-17, 11352-18, 25268-18 (U.S.T.C. July 19, 2024), ECF No. 366.

¹⁰ *CNT Investors, LLC v. Commissioner*, 144 T.C. 161, 197 n.38 (2015) (noting that “Congress has mandated [in Section 7701(o)] that, in applying ‘the common law doctrine under which tax benefits * * * with respect to a transaction are not allowable if the transaction does not have economic substance or lacks a business purpose’ to any transaction to which it is ‘*relevant*’, the Federal courts use a conjunctive test.”) (emphasis added).

¹¹ *Mazzei v. Commissioner*, 150 T.C. 138, 196 (2018) (Holmes, J., joined by Foley & Buch, JJ., dissenting), *rev’d*, 998 F.3d 1041 (9th Cir. 2021).