Economic Substance

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Bryon Christensen
Principal, EY

Brian Kittle
Partner, Mayer Brown

Rob Kovacev
Member, Miller & Chevalier

Ben Shreck
Tax Counsel, TEI

Agenda

- Economic Substance and "Relevance"
  - Statute and Notice 2010-62
  - *Patel* – Tax Court Opinion
  - *Liberty Global*
    - Facts
    - District Court Opinion
    - 10th Circuit Majority Opinion
    - 10th Circuit Dissent
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  - Pending cases
- IRS and Economic Substance – What is Exam Arguing?
- New Tax Disclosure Risk?

Economic Substance – Statutory Text

What the Statute Says

1. **Relevance.** "In the case of any transaction to which the economic substance doctrine is relevant . . . ." Relevance is determined "in the same manner as if this subsection had never been enacted." § 7701(o)(1), (5)(C).
2. **The test.** A transaction has economic substance "only if" it "changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position" and the taxpayer "has a substantial purpose (apart from Federal income tax effects)" for entering into it. Conjunctive.
3. **Profit potential.** Counts only if the present value of the reasonably expected pre-tax profit "is substantial in relation to" the present value of the expected net tax benefits. Fees are expenses; foreign taxes are expenses "in appropriate cases." § 7701(o)(2).
4. **Purposes that do not count.** State and local tax effects related to a federal effect, and financial accounting benefits that originate in a federal tax reduction. § 7701(o)(3), (4).
5. **"Transaction" includes a series of transactions.** § 7701(o)(5)(D).

What Congress Said It Did Not Mean to Disturb

The provision "is not intended to alter the tax treatment of certain basic business transactions that, under longstanding judicial and administrative practice are respected, merely because the choice between meaningful economic alternatives is largely or entirely based on comparative tax advantages." JCX-18-10.

"Angel List." Debt or equity; a foreign or a domestic entity; a subchapter C organization or reorganization; a related-party transaction at arm's length. Incentive credits are protected where the taxpayer does what the credit was meant to encourage.

The catch. The list is legislative history, not text; courts keep their power to aggregate, disaggregate, and recharacterize; and the IRS declined to publish an angel list of its own.

Notice 2010-62

IRS stated that ESD "only applies in the case of any transaction to which the economic substance doctrine is relevant."

Compare to the IRS's current position that there is no threshold relevance determination.

Patel v. Comm'r, 165 T.C. No. 10 (Nov. 12, 2025)

Facts

- Owners deducted payments to purported captive insurers and a reinsurer as Section 162 business expenses.
- The Tax Court had already held the arrangements were not insurance for federal tax purposes; the strict liability penalties put Section 7701(o) directly at issue.

Threshold Relevance Required

- "To put it plainly—the statute says so, right there, on its face. . . . Congress could hardly have been clearer."
- Courts must apply a threshold relevance inquiry under Section 7701(o)--economic substance doctrine is not relevant to every transaction.
- Consistent with the statute, relevance is determined under pre-codification common law. Captive-insurance precedent made the doctrine relevant here; the arrangements then failed the two-prong statutory test.

WHY IT MATTERS The Tax Court makes its first clear pronouncement on the scope of Section 7701(o)

Liberty Global: Facts & District Court

The Transaction

Project Soy. In June 2018, LGI "began to explore the possibility of exploiting a [so-called] loophole in the international tax provisions of the TCJA to shelter profits."

The steps. Entity classification and capitalization elections, followed by a sale of a Belgian subsidiary. The result was a § 245A deduction that did not have a corresponding inclusion.

The regulation. Treasury attempted to close the gap with retroactive temporary regulations, which the district court invalidated under the APA. The government then turned to economic substance, late in the summary-judgment briefing.

The Posture

Concessions. LGI admitted that steps 1 through 3 "did not change, in a meaningful way, LGI's economic position" and "served no substantial non-tax purpose." The only question was relevance.

District court (Oct. 31, 2023). No threshold relevance inquiry. The doctrine applies whenever a taxpayer claims benefits Congress did not intend through transactions with no purpose but tax savings.

Tenth Circuit (Apr. 21, 2026). Affirmed, 2–1. 174 F.4th 1208. Panel rehearing and rehearing en banc denied August 17, 2026, three of twelve active judges dissenting.

Liberty Global: 10th Circuit Opinions

The Majority (Murphy, J.)

1. "The economic substance doctrine codified in § 7701(o) is relevant to attempts by taxpayers to mechanically utilize the provisions of the Tax Code to obtain a benefit not intended by Congress."
2. The doctrine is not a mere interpretive tool. It can disallow benefits even where the taxpayer complied with the literal terms of the Code (citing *Blum*, 10th Cir. 2013).
3. The unit of analysis is the entirety of Project Soy. A taxpayer cannot escape § 7701(o) by including steps that are "basic business transactions."
4. On these facts, the relevance dispute was a "red herring."

The Dissent (Eid, J.)

1. Section 7701(o) "ma[d]e clear that there exists a mandatory relevancy determination before the government may invoke the economic substance doctrine."
2. Section 7701(o)(5)(C) supplies the method: the same approach courts used to invoke the common-law doctrine. The doctrine is not relevant where economic reality and taxpayer motive are irrelevant to the statutory language. Project Soy realized actual gain.
3. The majority "effectively hand[ed] the government a blank check to declare any transactions it does not like to be within" the doctrine.

Differing Readings of “Relevant”

District courts

D. Colo. 2023 (Liberty Global); S.D.N.Y. 2023 (Chemoil)

No separate gate. The doctrine is “relevant” whenever a taxpayer claims benefits Congress did not intend through transactions with no purpose but tax savings. Relevance collapses into the prongs.

Tenth Circuit majority

Liberty Global, 174 F.4th 1208 (Murphy, J.)

Relevant where the taxpayer “mechanically utilize[s]” Code provisions to obtain a benefit “not intended by Congress.” The whole plan is the transaction, and literal compliance is no defense.

The text camp

Eid, J., dissenting (joined at rehearing by Hartz and Tymkovich); Exxon Mobil; Summa Holdings

A mandatory threshold determination anchored in the operative provision. If economic reality and motive are irrelevant to the statutory language, the doctrine is out.

Tax Court

Patel, 165 T.C. No. 10 (reviewed; unanimous)

A distinct antecedent inquiry answered by history: did the pre-2010 case law apply the doctrine to this type of transaction?

Everyone invokes congressional intent and reads it from a different perspective: the text of the operative provision, the purpose behind the benefit, or ninety years of case law. Forum matters. Under *Golsen*, a Tax Court case appealable to the Tenth Circuit gets the Liberty Global reading.

Implications for Planning/Documentation

Process Is Important!

1. **Documentation of purpose**
2. **An economics model built the way § 7701(o)(2) is written**
3. **An alternatives analysis**
4. **Legal analysis**
5. **Step back regularly (do not become a frog in boiling water)**
6. **Conduct that matches the story**

How is the IRS using the ESD in Exam?

1. ESD increasingly invoked in transactions beyond the scope of traditional ESD cases
   - Assertions that taxpayers claiming tax credits must show that transaction would be profitable without tax credits
   - Assertions that taxpayers must have non-tax business purposes for steps that are purely creatures of the Code (e.g., check the box)
   - ESD is not relevant to these types of transactions, but taxpayers must still expend time and effort responding to these assertions
2. ESD sometimes used as an end-run around difficult technical tax issues when Exam does not like the underlying transaction
   - "I know it when I see it" is often the standard Exam employs

New Tax Disclosure Risk? Amgen Shareholder Derivative Lawsuit

1. IRS alleged Amgen underpaid taxes between 2010 and 2015
   - NOPAs issued in 2017 and 2020 totaling $10.7 billion in taxes, penalties, and interest (transfer pricing was underlying issue)
   - Amgen did not disclose assessments until August 2021 and April 2022
2. Shareholders sued alleging Amgen should have disclosed earlier
   - Share price dropped significantly once disclosed
   - Derivative suit survived motion to dismiss
   - Amgen settled for $74 million
3. Should taxpayers now disclose upon receiving a material NOPA?
   - Does IRS increased assertion of the statutory ESD increase this risk?