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Economic Substance Doctrine, Penalty Lie in Wait for Taxpayers

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It may be reasonable to conclude that the economic substance doctrine and penalty are zombies these days, lurking in the shadows even when a taxpayer has engaged in careful tax planning. Taxpayers should be mindful of even the slim possibility that the IRS will assert the doctrine.

When a transaction otherwise complies with the Internal Revenue Code, the IRS may employ the economic substance doctrine—one of several judicially created doctrines—to disallow the tax benefits claimed from the transaction.

Congress amended the tax code in 2010 to provide a statutory definition. Under Section 7701(o), for any transaction to which the economic substance doctrine is "relevant," the transaction is treated as having economic substance only if it changes the taxpayer's economic position in a meaningful way (apart from federal tax consequences) and the taxpayer has a substantial, non-tax purpose for the transaction.

Congress contemporaneously created an additional 20% or 40% penalty for transactions lacking economic substance. This is a strict-liability penalty, meaning that taxpayers may not raise defenses to it.

In 2022, the IRS issued an Internal Guidance Memorandum to clarify whether and when exam teams should apply the economic substance doctrine. By removing the previous requirement for executive approval, the guidance aimed to increase cases in which exam teams would assert the doctrine and the penalty.

But the IRS's assertion of the economic substance penalty remains rare. IRS Data Books don't report separate statistics on how often the IRS asserts the penalty and whether those assertions are successful. Only a handful of reported cases involve the economic substance penalty outside of enforcement against abusive transactions.

In multiple cases this year, the IRS determined to assess the penalty following an examination, but counsel conceded the penalty in litigation based on procedural foot-faults or further factual development.

In addition to whether the IRS is asserting the doctrine and the penalty, the questions of how and when the government does so are equally important. The government has raised the economic substance doctrine well after the audit phase, during litigation, in numerous recent cases.

This leaves taxpayers with less ability to evaluate their litigation hazards and related costs, and the argument often comes as a surprise. The strict-liability nature of the penalty makes this approach even more problematic.

For example, in *Patel v. Commissioner* , a case involving captive insurance, the IRS included the penalty in the relevant notices of deficiency but didn't assert the economic substance doctrine as a reason for disallowing the relevant deductions. The government raised the doctrine as an argument for the first time in the answer to the petition, after the taxpayer had already filed suit. Despite this, the US Tax Court last month sustained the government's argument.

Even when a taxpayer has already won a round of litigation on the merits, the economic substance doctrine may result in a loss.

In *Liberty Global, Inc. v. United States* , the taxpayer won summary judgment against the government, arguing that it met statutory requirements for a deduction under Section 245A and that later-enacted Treasury Regulations were invalid as applied. In the next phase of the litigation, the government successfully asserted that the economic substance doctrine invalidated the transaction. The case is on appeal with the US Court of Appeals for the Tenth Circuit.

Is this inconsistent state of play the future? I believe it is in the short term, having recently reviewed these issues within the IRS Office of Chief Counsel.

The 2022 internal guidance came after a long period when many experienced examiners were retiring or leaving the IRS, and when exam teams weren't routinely evaluating the judicial doctrines. While young, motivated staff have joined the agency over the last few years, it takes experience to know when the doctrine may be relevant, as the statute requires.

Continued staff attrition this year has only exacerbated the problem, as exam teams have been subject to rapid staffing, management, and administrative changes. Complex questions such as whether the economic substance doctrine applies have taken a backseat to more immediate concerns.

Even if taxpayers are confident of winning, they should prepare for a fight. The Internal Revenue Manual still contains the 2022 guidance, and the only reassurance is to be ready. When audited, taxpayers should expect the IRS to evaluate whether any large or unusual transaction has economic substance.

For example, the IRS has asserted the economic substance doctrine frequently to recharacterize related-party loans. Taxpayers must consider a few factors to ensure these loans will be respected for tax purposes.

To satisfy the first prong of the economic substance test, taxpayers should ask whether the loan is economically rational.

- What loan terms would the debtor receive from a third party?
- Is the debtor paying interest on the loan, if the note calls for it?
- Is the debtor making payments through journal entries, or are funds moving between the parties?

Regarding the second prong, contemporaneous documentation is critical.

- Are the loans being treated in a business-like manner?
- Were loans approved consistently with past practice (board approval, for instance)?
- How are the parties reflecting their payments internally?

A good example of well-documented related-party loans defeating assertion of the economic substance doctrine can be found in *Ill. Tool Works Inc. v. Commissioner* .

Also, the *Patel* opinion and the anticipated opinion in *Liberty Global* may provide clarity for taxpayers who are engaged in transactions that Congress has expressly sanctioned. *Patel* holds that relevance is a threshold determination. Even the IRS's 2022 internal guidance cautioned that the doctrine "may not be appropriate" if a targeted tax incentive is involved.

The best preparation for an IRS challenge is during the transaction. Taxpayers should think ahead about how an outside party would evaluate a transaction and make all efforts to document the economic value of the deal, its purposes, and their intent.

The cases are Patel v. Commissioner , T.C., No. 24344-17, decided 11/12/25 , and Liberty Global, Inc. v. United States , 10th Cir., No. 23-01410.

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