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How Relevant Is It? The Economic Substance Doctrine According to Liberty Global and Patel

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I. Introduction

Should courts respect a transaction for tax purposes, when it otherwise complies with the technical requirements of the Internal Revenue Code and regulations? When should a court take the next step and consider the economic substance of a transaction and its motivations?

In two highly-awaited court decisions – one recently issued by the U.S. Tax Court in *Patel v. Commissioner* and one forthcoming from the U.S. Court of Appeals for the Tenth Circuit in *Liberty Global, Inc. v. United States* – federal courts are considering the proper interpretation and application of the codified economic substance doctrine. In these recent cases, a federal district court and the U.S. Tax Court have taken conflicting views. [1] At issue is whether Section 7701(o) requires a relevancy determination before the doctrine's two-prong test is applied.[2]

II. Statutory Framework

When Congress codified the judicial economic substance doctrine in 2010, it established a two-prong test – (i) the transaction must meaningfully change the taxpayer's economic position; and (ii) the taxpayer must have a substantial non-tax business purpose. Congress enacted Section 7701(o) to resolve a prior split in the case law among the U.S. Circuit Courts of Appeals, with three different tests (conjunctive, disjunctive, and unitary) in use depending on where the taxpayer was located. The promulgation of the two-prong test was intended to clarify when and how the economic substance doctrine would apply.

Of note, the lead-in language to the codified test provides that Section 7701(o)(1) only applies to transactions "to which the economic substance doctrine is relevant." The statute itself does not specifically address when the doctrine is considered relevant or who should make that determination.

In 2010, the Joint Committee on Taxation provided commentary indicating that the doctrine was not relevant to certain "basic business transactions" (debt v. equity, choice of entity for foreign investment, subchapter C reorganizations, and others).[3] The Joint Committee guidance also stated that the codification of the doctrine was not intended to disturb "longstanding judicial and administrative practice" respecting certain types of transactions; however, there was no further explanation beyond the transactions listed in the commentary. In addition, the Internal Revenue Service ("IRS") issued Notice 2010-62, which provided that the IRS would not issue rulings or determination letters on whether the doctrine was "relevant" to specific fact patterns.

In short, although Congress intended for codification of the economic substance doctrine to resolve conflicting case law and judicial interpretations, significant uncertainty regarding whether the doctrine is "relevant" to a particular case remains. The economic substance doctrine has been asserted sparingly since 2010 and, thus, little judicial authority interprets the new statutory language.

This uncertainty creates substantial risk for taxpayers potentially subject to the economic substance doctrine. Under Section 6662(b)(6) and Section 6662(i), the IRS may assess accuracy-related penalties of 20% and 40%, respectively, upon transactions lacking economic substance. Unlike other accuracy-related penalties, there are no taxpayer defenses (like "reasonable cause") available to avoid penalties.

III. *Liberty Global*

In its decision in *Liberty Global, Inc. v. United States*, the U.S. District Court for the District of Colorado stated its view of the proper application of the economic substance doctrine, as codified in 7701(o). The taxpayer had urged the district court to adopt a reading of the statute that gave meaning to the phrase "to which the economic substance doctrine is relevant," and argued that the statute required a threshold inquiry into relevance before applying the two-prong statutory test. The district court rejected this reading, citing to two Tenth Circuit cases on the economic substance doctrine that predated codification.[4] As the court held, "[t]o manufacture an additional question here—which as [the taxpayer] argues would then short-circuit the entire statutory analysis—would contravene the Tenth Circuit's instructions and frustrate the purpose of the doctrine itself."

The district court read the relevancy language in the statute as not imposing any additional requirement beyond the two-prong statutory test of Section 7701(o)(1). Finding that the doctrine is "relevant" when it is applicable, the district court read the relevancy determination to be coextensive with the two-prong operative test. In support, the district court cited other Tenth Circuit cases which did not engage in a relevancy analysis before applying the economic substance doctrine as evidence that there is no such threshold requirement. Based upon this reading of the statute, the district court applied the operative prongs of the test to disallow the taxpayer's claimed deduction. The case is on appeal to the U.S. Court of Appeals for the Tenth Circuit and has been fully briefed and argued. An opinion is expected in 2026.

IV. *Patel*

In *Patel v. Commissioner*, the Tax Court also confronted the question as to whether Section 7701(o)(1) requires a separate, threshold determination that the economic substance doctrine is "relevant" to a transaction before applying the operative two-prong test. The Tax Court's reasoning rested heavily on statutory interpretation, and was a reviewed, unanimous opinion of the court.

According to the Tax Court, a relevancy determination *is* required – "the statute says so, right there, on its face." The Tax Court pointed out that the lead-in language to the two-prong test compels a distinct and a preliminary relevancy inquiry; otherwise, the statutory reference to "relevant" would be meaningless. In support of that reasoning, the Tax Court pointed to Section 7701(o)(5)(C), which directs courts to determine relevance "as if this subsection had never been enacted."

For the Tax Court, Section 7701(o)(5)(C) confirmed that Congress intended for courts to continue applying the traditional common law criteria for when the economic substance doctrine should be invoked, rather than assuming relevance whenever a transaction produces tax benefits. The Tax Court analyzed the legislative history to the statute, noting that Congress described the statute as a codification and not an expansion of existing jurisprudence. Accordingly, the Tax Court reasoned that the doctrine was meant to apply only in circumstances where courts had historically found it proper to disregard tax-motivated structures. In sum, the Tax Court concluded that relevance of the economic substance doctrine must be established as an antecedent to the two-prong test in Section 7701(o)(1).[5]

V. Conclusion

The conflicting approaches taken by the *Liberty Global* and *Patel* courts highlight a broader policy debate about how expansively the economic substance doctrine should be applied to tax planning strategies, especially in light of the enduring principle from *Gregory v. Helvering* that "the legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted."[6]

In *Liberty Global*, the district court adopted an approach that integrates the relevancy determination into the substantive analysis itself – relevance is assumed whenever a transaction fails the two-prong statutory test. This approach would allow the IRS to proceed to the two-prong test without first demonstrating why the doctrine should apply at all, and, as a result, the doctrine could reach transactions that might otherwise fall outside of its historical contours.

Conversely, the Tax Court in *Patel* treated the "to which the economic substance doctrine is relevant" language as a real limitation, not as surplusage – the relevancy determination is a distinct, antecedent step to the two-prong test. This approach limits the doctrine's reach to transactions in which judicial scrutiny historically applied, protecting legitimate or congressionally endorsed tax planning strategies. Under the Tax Court's reading of the doctrine, the legislative purposes behind each claimed tax benefit and the taxpayer's motivations for entering into transactions become highly probative, and taxpayers would do well to carefully document their consideration of these elements at the time they participate in a transaction that could be subject to IRS challenge.

With *Liberty Global* currently on appeal to the Tenth Circuit, the divergence in how courts apply the economic substance doctrine persists, creating uncertainty for taxpayers. While recent guidance from the IRS confirms that examiners must still evaluate whether the doctrine is relevant to a transaction before the two-prong test is applied,[7] taxpayers are not entitled to rely on this IRS guidance.

Further judicial development of the economic substance doctrine may have practical significance for tax planning of many different business transactions, but the impact of these two decisions is currently unknown. For example, basic business transactions like the ones expressly listed in the 2010 Joint Committee commentary likely have strong defenses to any review under the economic substance doctrine. On the other hand, transactions like the one at issue in *Patel*, a micro-captive insurance strategy that the IRS has deemed a reportable transaction, are likely to be analyzed under the economic substance doctrine regardless of its judicial interpretation. Related-party transactions historically have been subject to scrutiny under the doctrine but also frequently survive that scrutiny. Because the law under the economic substance doctrine remains unclear, careful attention to forum and how relevance is addressed can be critical in shaping the outcome of economic substance disputes.

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[1] *Liberty Glob., Inc. v. United States* 2023 Us Dist Lexis 209613 (D. Colo. Oct. 31, 2023); *Patel v. Comm'r*, 165 T.C. No. 10 (Nov. 12, 2025).

[2] All references to section are to the Internal Revenue Code of 1986, as amended.

[3] Staff of the Joint Comm. on Taxation, Technical Explanation of the Revenue Provisions of the "Reconciliation Act of 2010," as amended, at p. 152.

[4] *Blum v. Commissioner*, 737 F.3d 1303 (10th Cir. 2013), cited by the court, was decided post-codification; however, it related to deficiencies for 1998 and 1999, pre-codification tax years to which the statutory doctrine did not apply.

[5] Currently, the time has not yet run for an appeal of the *Patel* decision. The decision notes that the taxpayers are in Texas, which would suggest an appellate venue of the U.S. Court of Appeals for the Fifth Circuit, barring a stipulation to the contrary by the parties. I.R.C. § 7482.

[6] *Gregory v. Helvering*, 293 U.S. 465, 469-70 (1935).

[7] *See generally* Internal Revenue Service LB&I-04-0422-0014, "Interim Guidance Memorandum on Economic Substance Doctrine and Related Penalties" (Apr. 22, 2022).

Related Professionals

- **Amanda H. Nussbaum**
  Partner
- **Christine Harlow**
  Partner
- **Malcolm S. Hochenberg**
  Partner
- **Martin T. Hamilton**
  Partner
- **Richard M. Corn**
  Partner
- **Stuart L. Rosow**