

Tax Court's Economic Substance Foray May Clarify Limits

By **Kat Lucero**

Law360 (August 7, 2024, 4:10 PM EDT) -- A U.S. Tax Court judge plans to address an ill-defined provision governing the relevance of the economic substance doctrine in a microcaptive insurance case, offering the courts another chance to clarify an anti-abuse tool the IRS has been deploying more often.

In an order July 19, Judge Courtney D. Jones sought input from the Internal Revenue Service and the couple who brought the case, Sunil S. Patel and Laurie McNally-Patel, about whether the doctrine requires an initial analysis to determine its relevance in a scrutinized transaction under Internal Revenue Code Section 7701. The judge also asked for nonparties to submit amicus briefs by Aug. 23 since the case will wade into territory that is novel to the Tax Court.

The order comes as telecommunications giant Liberty Global wages a high-profile battle to overturn a district court decision that invalidated the company's \$109 million foreign tax deduction on the grounds that the underlying transactions — known as Project Soy — lacked economic substance. In that case, a Colorado federal judge said courts are not required to conduct an initial analysis before applying the doctrine's test to a disputed transaction. That decision reflected an expansive reading of Section 7701 that could embolden the IRS to apply the doctrine to more transactions.

The Patels' case offers the Tax Court a chance to weigh in on the threshold analysis question in economic substance cases. Judge Jones is sure to take a measured approach to the issue, considering its potentially widespread impact, practitioners told Law360.

"The court wants to be thoughtful and considerate about this because [the decision] could have wide-ranging implications" — not just for the Patels' insurance transactions, but also for other arrangements that the IRS is challenging — said Jean Pawlow, a partner at Latham & Watkins LLP.

The common-law economic substance doctrine has long been at the government's disposal to go after



If the Tax Court rules against the IRS in a suit involving the relevance of the economic substance doctrine in a microcaptive insurance case, it could put some new limits on the agency, some experts say. (iStock)

what it sees as abusive tax avoidance practices. The IRS, however, has historically used it sparingly, and courts typically have viewed it as having a limited scope.

To set a consistent standard to determine a tax transaction's economic substance, Congress codified a two-prong conjunctive test for the doctrine under Section 7701 — along with a strict liability penalty of 20% under IRC Section 6662 for transactions that fail to meet the test — as part of the Health Care and Education Reconciliation Act of 2010.

Two years ago, the IRS relaxed executive approval rules for asserting economic substance penalties, which practitioners said has led the agency to impose more of the associated penalties in transactions under audit.

Then, last year, the Colorado district court asserted a wider interpretation of the IRS' authority under Section 7701 in rejecting Liberty Global's arguments that courts are required to conduct a threshold inquiry before applying the two-part test. That decision had denied the multinational company's refund claim, saying the underlying intercompany sales did not have economic substance other than to significantly shrink its tax bill.

Liberty Global is now appealing the decision at the Tenth Circuit, which has also garnered amicus filings from business groups critical of the lower court's interpretation of the doctrine.

The National Association of Manufacturers, for example, said in a brief that the district court's failure to make a relevance determination had turned the statute's "reference to transactions to which the doctrine 'is relevant' upside-down" and conflicted with Congress' intentions for Section 7701.

While concerns about the IRS' use of the doctrine have been publicly raised in transfer pricing cases, the Patels' suit demonstrates that the agency's scrutiny of transactions for economic substance goes beyond international tax transactions, said Thomas V. Linguanti, a partner at Morgan Lewis & Bockius LLP.

What is new in the Tax Court's inquiry is an IRS that has been "clear that it is looking to apply the so-called statutory economic substance doctrine in ways" in which it has never been applied before, he said.

"It's now become an almost automatic area of inquiry by the IRS," Linguanti said. "It's crossing all sorts of lines that we hadn't seen crossed before."

At issue in the Patels' case is their claim for a deduction of more than \$4.5 million in insurance premiums they paid to two microcaptive companies. The IRS has been cracking down on microcaptive transactions after finding they have the potential for abuse. In a March 26 decision, Judge Jones ruled the Patels were not entitled to the deduction and a separate opinion would address accuracy-related penalties asserted by the IRS.

In the July 19 order, the judge said accuracy-related penalties for 2013 through 2016 remained at issue, some of them due to the lack of economic substance. The Patels have asserted that Section 7701(o), which says the doctrine is applied "in the case of any transaction to which the economic substance doctrine is relevant," is ambiguous, while the IRS did not address whether that provision required a threshold determination, according to the order.

Melissa Wiley, a partner at Lowenstein Sandler LLP, said that under the Patels' interpretation, the court

must first conduct a determination on whether Section 7701's two-prong test is relevant to their circumstance before the IRS imposes the penalties, while the government so far hasn't put forth any strong arguments in favor of being able to assert accuracy-related penalties for lack of economic substance.

"The government hasn't made any arguments that would lead us to the conclusion that the penalty is relevant here," she said.

If the Tax Court sides with the Patels' interpretation, it could put some limits on the IRS' aggressive assertion of the doctrine, Linguanti said.

In most taxpayers' perspective, the relevancy issue is "unquestionably a gating item," Linguanti said. If the Tax Court agrees with that position, then the decision is "going to have an effect on the IRS' use of that doctrine."

--Additional reporting by Anna Scott Farrell. Editing by Aaron Pelc and Roy LeBlanc.

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