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# Court News: Economic Substance Doctrine Nullifies Transaction

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The IRS won a major economic substance case on October 31. A federal district court in *Liberty Global, Inc. v. United States*, No. 20-cv-03501 (D. Colo.), found that a planned corporate transaction lacked economic substance. The economic substance decision resulted in the denial of an approximately \$110 million tax refund but also, due to the stipulation of the parties, controls the outcome of a related case where the Government sued the company for \$236 million in additional taxes and \$47 million in additional penalties.

## The Four Step Transaction

The *Liberty Global* opinion describes the transaction as a four-step plan designed to exploit a mismatch created by the 2017 Tax Cuts and Jobs Act, Pub. L. No. 115-97, 131 Stat. 2054, between (1) the rules for paying tax on global intangible low taxed income (GILTI) and subpart F tax on a gain generated by a controlled foreign corporation (CFC), and (2) the qualification of an entity as a CFC. The first three steps generated earnings and profits to offset LGI's taxable gain on Step 4 of the plan, called the "TGH Transaction." LGI claimed the TGH Transaction qualified for an IRC Section 245A deduction.

## The Court's Application of the Economic Substance Doctrine

The economic substance doctrine, codified at 26 U.S.C. § 7701(o), provides in relevant part:

In the case of any transaction to which the economic substance doctrine is relevant, such transaction shall be treated as having economic substance only if—(A) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and (B) the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction.

The ruling contains many key take-aways about how courts might apply the economic substance doctrine to planned corporate transactions:

- The prefatory clause in the statute – “In the case of any transaction to which the economic substance doctrine is relevant” – does not require a separate threshold analysis into whether the doctrine is “relevant” to the transaction at issue. The doctrine applies whenever the two statutory prongs are satisfied. Opinion p.7-10.

- Two “red flags” that a transaction has no economic substance are “when a transaction produces enormous tax savings without a concomitant economic loss, or when something smack[s] of a too-good-to-be-true transaction and lacks an appreciable effect, other than tax reduction.” Opinion p.9.
- The economic substance analysis is “necessarily flexible,” and a court may aggregate, disaggregate, or otherwise recharacterize a transaction when applying the doctrine in order to effectuate Congress' purpose. The court looked at steps 1-3 collectively, against LGI's arguments to examine step 3 in isolation, because the steps were all related to the tax loss that LGI claimed and it was unlikely they would have been taken except for in contemplation of the TGH transaction in step 4 that was at issue. Opinion p.11-12.
- The reference in the legislative history to an exemption for “basic business transactions” does not apply to a complex transaction with a “full choreography of sub-transactions.” Opinion p.14-16.

#### **Impact on the Related Liberty Global Case**

The Government had filed a related action pending in the same court, *United States v. Liberty Global, Inc.*, No. 22-cv-02622 (D. Colo.). In that case, the Government seeks a whopping amount of tax of \$236 million and penalties in the amount of \$47 million. In a joint status report and submission of proposed judgments, the parties advised that the court's decision would resolve the “dispute at the core of [the Government's action], leaving only computational issues that the parties believe can be resolved through stipulation.” It is unclear how the parties intend to address the penalty issues.

#### **Expected Increased IRS Use of the Economic Substance Doctrine**

In 2022, the IRS announced plans to consider the doctrine's application more frequently in audits and removed approval barriers for examiners to assert the economic substance doctrine (see LB&I-04-0422-0014; Apr. 22, 2022) This major court victory for the IRS will likely encourage more assertions of economic substance theories and penalties against corporate taxpayers.

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