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Legal Update

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United States: Economic Substance Doctrine after *Liberty Global*

In the nose of the beholder: the ESD as a smell-test

The Baker Tax Team analyzes the impact of recent rulings on the Economic Substance Doctrine.

In brief

Recent court decisions, including *Liberty Global v. United States*, *Patel v. Commissioner*, and *Otay v. Commissioner*, addressing the economic substance doctrine (ESD) have exceeded and distorted the codified language of section 7701(o) such that the resulting doctrine begins to more closely resemble a general anti-avoidance rule (GAAR) rather than the narrowly tailored rule enacted by Congress. These decisions raise concerns regarding judicial overreach and further embolden the Internal Revenue Service (IRS) to take more aggressive positions on the ESD in audit and in litigation. The resulting legal environment makes it more important for taxpayers to build a contemporaneous record showing both why the doctrine should not apply and the transaction's non-tax business purpose.

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Key takeaways

The ESD has taken center stage in recent cases of *Liberty Global, Inc. v. United States*, *Patel v. Commissioner*, and *Otay v. Commissioner*. These decisions have had the effect of muddying the fraught area of the ESD interpretation and application such that the ESD has taken the shape of a GAAR rather than the narrowly tailored rule Congress enacted.

- When Congress codified the ESD in 2010, it imposed a threshold limitation: the doctrine applies only to transactions to which it is "relevant," with relevancy determined by reference to pre-2010 common law — reflecting a deliberate judgment that not every tax-motivated transaction is subject to scrutiny under the ESD.
- In *Patel v. Commissioner*, the Tax Court confirmed that section 7701(o) requires a separate threshold relevance determination that is not coextensive with the two-prong economic substance test itself.
- In *Otay*, a recently decided case involving pre-codification transactions, the Tax Court applied the ESD to a transaction governed by a mechanical provision of the Code.
- In *Liberty Global Inc. v. United States*, the Tenth Circuit effectively collapsed the relevance threshold into a purposive inquiry, holding that the ESD was relevant to any transaction that produces a benefit the court viewed as "unintended" by Congress, even where the taxpayer complied with the literal mechanics of the Code.

In response to the uncertainty created by these decisions, clients should:

- Consider the relevance of the ESD to their transactions, both as a whole and in their component parts, keeping in mind the weakened persuasiveness of the "Angel's List."
- Separately determine if the transaction satisfies the objective and subjective prongs of the economic substance analysis under section 7701(o)(1).
- Prepare early and build a record of this analysis in preparation for more aggressive audits.

In more detail

Introduction

The ESD has long been among the federal tax system's most contested judicial tools. In some cases, courts have used it to disregard transactions that technically comply with the Internal Revenue Code but are viewed as having no purpose or practical effect beyond reducing tax. In more recent decisions, courts have framed the doctrine as a method of discerning the purpose Congress expressed in statutory text. However formulated, the doctrine has been invoked to deny deductions, disallow losses, and recharacterize transactions. When applied aggressively, it can be used to override the express mechanics of provisions Congress enacted and taxpayers followed.

Recent ESD cases diverge sharply on the threshold "relevance" inquiry under section 7701(o). The Tax Court's reviewed opinion in *Patel v. Commissioner*, 165 T.C. No. 10 (2025), holds that relevance is a mandatory, antecedent determination grounded in statutory text and pre-2010 common law. Another recent Tax Court opinion, *Otay v. Commissioner*, T.C. Memo. 2026-21, examined the ESD pre-codification but did not engage in a meaningful relevance analysis. By contrast, the Tenth Circuit's decision in *Liberty Global Inc. v. United States*, No. 23-1410 (10th Cir. Apr. 21, 2026), while acknowledging the relevance requirement, effectively collapses it into a purposive inquiry — asking whether the taxpayer obtained a benefit the court today views as "unintended" by Congress. Although binding only within the Tenth Circuit, *Liberty Global* is likely to influence IRS and Department of Justice (DOJ)positions nationwide and increase exam and litigation risk for most any transaction.

Background: the economic substance doctrine before and after 2010

The common law doctrine

The ESD ostensibly traces its origins to the Supreme Court's decision in *Gregory v. Helvering*, 293 U.S. 465 (1935), which held that a corporate reorganization structured to comply with the literal terms of the tax code could nonetheless be disregarded if it lacked any business purpose independent of tax avoidance. *Gregory* was decided in a more "flexible" era of statutory interpretation when subjective notions of purpose could override clear legislative text. Indeed, the drafter of the appellate decision reflected on purposive interpretation in a later case applying the "doctrine."[i] Over the following decades, lower courts morphed the doctrine into a multi-factor inquiry that asked, in various formulations, whether a transaction had objective economic effects beyond tax reduction and whether the taxpayer had a subjective non-tax business purpose in undertaking it.

By the early 2000s, the doctrine had fractured across the federal circuits.[ii] Some circuits applied the objective and subjective prongs conjunctively requiring taxpayers to satisfy both. Others applied them disjunctively, sustaining a transaction if either prong was met. Still others used a holistic, unitary approach that weighed the factors together without treating either as independently dispositive. The result was a geography-dependent system of tax enforcement: a transaction might survive scrutiny in one circuit and be disallowed in another based not on differences in the underlying law or the underlying facts but simply on the accident of where the taxpayer happened to be located.

Congress addressed this fragmentation in the Health Care and Education Reconciliation Act of 2010 by adding section 7701(o) to the Code.[iii] That provision required the application of the doctrine in its conjunctive form mandating that both objective economic effects and a subjective non-tax purpose be present for a transaction to be respected. But Congress also imposed a threshold limitation: section 7701(o) applies only to transactions "to which the economic substance doctrine is relevant." Section 7701(o)(5)(c) further specifies that relevancy is to be determined "in the same manner as if this subsection had never been enacted" — that is, by reference to the pre-2010 common law.

This relevance requirement reflects a deliberate legislative judgment. Not every tax-motivated transaction is subject to economic substance scrutiny. Before enactment of section 7701(o), courts routinely declined to apply the doctrine to transactions involving the straightforward application of clear statutory provisions or to choices among explicitly sanctioned alternatives.[iv] Congress preserved that limitation in the statute and made the relevance determination a threshold question.

Even under the pre-2010 common law, courts did not apply the ESD indiscriminately to every transaction. Historically, economic substance scrutiny was applied selectively most often where the operative statute's terms imposed an economic inquiry and the facts of the transaction made economic substance scrutiny appropriate. The threshold question — whether a transaction is the kind to which the doctrine applies — was (and remains) a real limiting principle. However, a recently decided pre-codification case, *Otay v. Commissioner*, failed to identify any limiting principle for the ESD's application. In *Otay*, the Tax Court sustained the disallowance of a section 743(b) basis adjustment and, in an alternative "holding," applied the common law ESD without conducting a meaningful relevance analysis. Although section 7701(o) did not apply to the tax years at issue, the Tax Court's opinion relied on broadly framed Supreme Court precedent to justify disregarding transactions that complied with the Code's literal terms but allegedly lacked "economic reality" without explaining why economic substance scrutiny was appropriate for a mechanical provision like section 743(b). The Tax Court's failure to opine on the limits of the ESD opens the door for the government to apply the ESD as a free-floating override, applicable to virtually any transaction perceived as tax-motivated.

Post-codification ESD case law – *Patel v. Commissioner*

The Tax Court had its first opportunity to consider the scope of section 7701(o)'s relevance requirement in *Patel v. Commissioner,* 165 T.C. No. 10 (2025). In its reviewed opinion, the court held that the statute requires a threshold determination of relevancy before the two-prong economic substance test applied.[v] Critically, the court also held that the relevancy inquiry is not coextensive with the two-prong test itself — it is a separate, antecedent question that must be resolved on its own terms. The *Patel* court's analysis proceeded directly from the statute's text. Section 7701(o)(1) conditions application of the doctrine on a finding that the doctrine is "relevant" to the transaction in question. The court emphasized that Congress "could hardly have been clearer" that relevance is not coextensive with the two-prong test and that treating relevancy as merely another way of asking whether the transaction lacked economic substance would nullify the condition — any transaction found to lack economic substance would necessarily be deemed relevant, and the threshold requirement would collapse into the merits inquiry.[vi] That reading would render the limiting language of the statute meaningless, contrary to basic principles of statutory construction. The Tax Court went as far as to note that "we respectfully disagree with other courts that have held that the relevance requirement is coextensive with the requirements of section 7701(o)(1)(A) and (B)," referencing the District Court of Colorado's *Liberty Global* decision.[vii]

Patel thus confirms what the text of section 7701(o) and the common law has always said: the ESD does not apply automatically to every transaction that touches a Code provision. The government must first establish that the doctrine is relevant before the two-prong analysis is reached. However, while *Patel* affirmed the existence of a relevance threshold, it provided less clarity as to the determination of when the ESD is relevant. The Tax Court instructed that a relevance determination requires examination of whether pre-codification case law has applied the ESD in analogous circumstances. Specifically, the Tax Court looked to "cases involving insurance transactions and, in particular, captive insurance transactions" to determine whether it was appropriate to apply the ESD in the instant case.[viii] Although the court provided limited clarity on the application of the relevance threshold, it did cabin its inquiry for analogous cases to a narrow subset of pre-codification ESD cases specific to the issue at hand in *Patel*. In a footnote, the Tax Court suggested further preservation of judicial discretion in that "courts have the same flexibility to identify relevant contexts for application of the codified doctrine as they possessed before codification."[ix] *Patel* has already emboldened the IRS to seek expansive application of the ESD by broadly analogizing to open-ended categories in which courts sometimes applied pre-codification ESD.

The *Liberty Global* decision

Overview

Most recently, the Tenth Circuit affirmed the district court's application of section 7701(o) disallowing a USD 2.4 billion section 245A dividends-received deduction claimed by Liberty Global as a result of a series of transactions referred to as "Project Soy." Project Soy involved a check-the-box election for a Luxembourg subsidiary, an internal asset reorganization, and a subsequent liquidation. In district court, the taxpayer conceded that Project Soy did not satisfy the two-prong economic substance test. The appeal therefore turned on whether the doctrine was relevant to the transaction.

Relevance standard

The Tenth Circuit held that the codified ESD is relevant to any "attempts by taxpayers to mechanically utilize the provisions of the Tax Code to obtain a benefit not intended by Congress."[x] It rejected the argument that literal compliance with statutory mechanics or inclusion of "basic business transactions" precludes application of the doctrine, and it endorsed an integrated-transaction approach that treated the entire plan as the appropriate unit of analysis. Although the panel acknowledged section 7701(o)'s relevance language, it characterized the issue as a "red herring," effectively folding the threshold inquiry into a purposive assessment of "unintended" benefits — as seen by the court today in hindsight and based on the court's own subjective notions of congressional "intent."[xi] The court looked to historical applications of the ESD to reject the argument that the ESD cannot apply if the taxpayer complied with the actual language of the Code. The Tenth Circuit collected cases in forming its conclusion that "[f]or decades, transactions that 'comply with the literal terms of the tax code' have been disregarded for tax purposes under federal common law if they have no economic substance but are, instead, mere tax-avoidance schemes."[xii]

The Tenth Circuit went on to disavow the taxpayer's reliance on the "Angel's List" from section 7701(o)'s legislative history to assert that Congress intended to exempt certain "basic business transactions" from the ESD application. The court affirmed part of the district court's opinion, which found that the Angel's List "does not state or imply that any transaction that merely includes a reorganization is likewise exempt" and that "[t]here is no basis to conclude from the fact that one step of Project Soy might fall within an exception that the transaction in aggregate — the appropriate unit of analysis here — should be excepted."[xiii] The court did acknowledge that the ESD may not apply to certain "basic business transactions" in certain circumstances but the inclusion of one such transaction within a series of transactions does not exempt the full transaction from the ESD.

While the *Liberty Global* opinion is binding only within the Tenth Circuit, it conflicts with *Patel*'s treatment of relevance as a genuine threshold inquiry and will be cited aggressively by the IRS and DOJ as persuasive authority in examinations and litigation nationwide.

"Transaction" definition

The Tenth Circuit affirmed the district court's determination that the "proper unit of measurement for application of the ESD was the entirety of Project Soy."[xiv] In the district court, the taxpayer argued that the inquiry of the ESD should be applied to the discrete step that generated earnings and profits (E&P), rather than evaluating Project Soy as a whole. However, the district court rejected this framing — in the court's view, E&P standing alone does not constitute a "tax benefit" for purposes of the ESD analysis; it is merely an intermediate "component." Accordingly, the district court's unit-of-analysis inquiry focused not on any intermediate tax attribute produced along the way, but on the transaction that gave rise to the actual, claimed tax benefit — in that case, Project Soy in the aggregate which created a USD 2.4 billion section 245A dividends-received deduction.

The Tenth Circuit considered the timing of the transactions and the court's notion of their purpose as the determinative factors for analyzing the transactions together rather than in their individual parts. Agreeing with the district court, the Tenth Circuit determined that "Project Soy was a tightly integrated series of transactions that took place over a short, four-day period for the specific purpose of taking advantage of an unintended 'mismatch' in the international tax provisions of the Tax Cuts and Jobs Act (TCJA)."[xv] Without providing a framework for determining when a transaction should be considered holistically rather than each step independently, the court descended into a parade of horribles: "If this court gave its imprimatur to the rule advocated for by LGI, taxpayers, tax professionals, and attorneys would quickly find ways to inoculate their complex transactions from application of § 7701(o) by including therewithin 'basic business transactions.'"[xvi]

As supported by both the district court's and the Tenth Circuit's opinions, the appropriate unit of analysis must be anchored to the actual tax benefit claimed — requiring the IRS, in order to properly invoke the doctrine, to clearly articulate the specific tax benefit being challenged and the Code provision that the taxpayer is allegedly circumventing or improperly utilizing.

The Economic Substance Doctrine as a de facto general anti-avoidance rule

The GAAR problem in American tax law

GAARs typically authorize tax authorities to disregard or recharacterize transactions viewed as abusive or lacking genuine non-tax purpose, even if they satisfy the law's technical requirements. The United States has no statutory GAAR. Congress has considered and declined to enact one on multiple occasions, opting instead for targeted, transaction-specific anti-abuse provisions drafted to address identified problems.

The absence of a GAAR reflects an intentional separation-of-powers judgment: overriding transactions that comply with the Code is a legislative decision, best made through democratic processes and drafted with specificity. A GAAR effectively delegates to tax administrators and courts the power to decide which transactions Congress "would have wanted" to permit. Given the breadth of that authority, it resembles the kind of "major question" the Supreme Court has said belongs to the legislature rather than an agency.[xvii] That is why a *meaningful* threshold relevance inquiry matters: without it, courts and an overzealous tax authority can use the ESD as a broad override even where Congress has spoken clearly.

That concern leads to an even more fundamental question: *could* Congress enact a GAAR, even if it wanted to? A rule allowing the IRS to override the entire detailed tax code whenever it chooses would functionally delegate Congressional revenue raising powers to the Executive with the only "intelligible principle" of "preventing abuse," i.e., raising more revenue. If that were enough of a principle to overcome the non-delegation doctrine, then why have a legislature with core tax raising functions at all?[xviii]

The economic substance doctrine as a judicial GAAR

Recent cases underscore the risk that the ESD is being applied as a *de facto* GAAR. When courts dispense with a meaningful threshold relevance inquiry, the doctrine can become a vehicle for overriding the Code based on an after-the-fact assessment that the taxpayer's result seems "too good" or inconsistent with an implied anti-abuse purpose — rather than on statutory text and historically recognized limits. That is a GAAR in *substance*.

In *Liberty Global*, the court embraced a purposive inquiry untethered to statutory text. The Tenth Circuit distinguished the Sixth Circuit's decision in *Summa Holdings*, in which the court declined to apply the ESD to transactions involving Roth IRAs on the ground that Congress expressly intended the tax benefits those vehicles provided — even where the magnitude of the benefit was substantial. Here, the Tenth Circuit stated that, unlike in *Summa Holdings*, "nothing in the TCJA evidences any similar intent to provide *massive tax benefits* for the admittedly economically meaningless transactions at issue here."[xix] In drawing that distinction, the court effectively arrogated to itself the authority to determine the outer bounds of a permissible tax benefit: where Congress has not affirmatively signaled that a benefit of a given magnitude is intended, the benefit is presumptively subject to economic substance scrutiny. That reasoning inverts the proper interpretive framework. Rather than asking whether the statute's text forecloses the claimed result, the court asked whether Congress affirmatively blessed it — and treated the absence of such affirmative evidence as license to disallow the benefit. Where a court can disallow a tax result arising from the mechanical application of the Code as enacted by Congress simply because the benefit exceeds what the court considers "appropriate," the court has essentially created a GAAR.

The D.C. Circuit's decision in *Horn v. Commissioner*, 968 F.2d 1229 (D.C. Cir. 1992), provides a useful counterpoint for this corrupted analysis. In *Horn*, the court properly characterized the ESD not as a freestanding anti-avoidance rule but as a tool of statutory interpretation — a means of discerning Congressional intent through legislative text.[xx] On this view, the doctrine is a disciplined inquiry into legislative intent, not an invitation for courts to impose their own sense of what transactions ought to be respected based on a purposive inquiry into subjective notions of "abuse" or revenue raising.

Horn's framing is the most defensible account of the doctrine. But it also illuminates precisely what is wrong with the way courts have applied it in cases like *Otay* and *Liberty Global*. If the ESD is a tool of statutory interpretation, then it can have no proper application to a mechanical provision like section 743(b) that is neither ambiguous nor incomplete. When a statute clearly prescribes a mandatory adjustment under specified conditions, there is no interpretive gap for the doctrine to fill. Applying the doctrine anyway — without explanation, in the alternative, after the case has already been resolved on statutory grounds — is not statutory interpretation. It is executive policymaking in the form of a GAAR instead of in the form of regulations (and without even any of the notice-and-comment or reasoned decision making protections inherent in the promulgation of the latter).[xxi] The Tenth Circuit even cites *Horn* in *Liberty Global* to confirm that "Congress can certainly enact a tax benefit that explicitly applies even in economically meaningless transactions."[xxii] Yet, the court applies the doctrine anyway.

Once courts apply the doctrine whenever they find a fact pattern sufficiently unattractive, the line between economic substance and a GAAR collapses. The doctrine becomes a "smell test": if a transaction maximizes a tax result under the Code's literal terms and the court finds the outcome unappealing, the ESD becomes available to disallow it — regardless of statutory text, historical limits, or evidence that Congress intended the result. That is not interpretation; it is judicial legislation.

The power grab of courts from Congress

When Congress codified the ESD in 2010, it acted against a backdrop of doctrinal inconsistency and, more importantly, doctrinal overreach. The circuit split Congress resolved was not only a dispute about conjunctive versus disjunctive application; it was a symptom of a broader problem: courts were applying the doctrine in varying and unpredictable ways, without a stable framework for determining when the doctrine should apply at all. That unpredictability created uncertainty for taxpayers attempting to assess risk for transactions that appeared to comply with the Code.

Congress's response was calibrated. Section 7701(o) clarified that the two-prong test applies in its conjunctive form and, critically, imposed a threshold relevance requirement. That requirement embeds two legislative choices.[xxiii] First, the doctrine does not apply to every transaction — relevance must be established as a condition of applying the test. Second, relevance is to be determined in part by reference to pre-2010 common law, meaning courts must look to how the doctrine was historically applied. The recent uptick in economic substance litigation has coincided with a shifting administrative law landscape, notably *Loper Bright Enterprises, Inc. v. Raimondo,* 603 U.S. 369 (2024). *Loper Bright* curtailed *Chevron* deference, meaning courts are less likely to defer to the IRS or Treasury interpretations of ambiguous tax statutes**.** With less deference to agency guidance, judges may feel freer to apply anti-abuse doctrines like the ESD based on their own view of legislative purpose. In *Liberty Global*, the majority effectively substituted its view of congressional purpose for statutory text, prompting Judge Eid's sharp dissent to warn that the decision "abandons its responsibility to meaningfully interpret text and precedent and merely looks to the 'purpose of the statute,' effectively handing the government a blank check to declare any transactions it does not like to be within the doctrine."[xxiv]

When a court applies a judicial doctrine to override the express mechanics of a statutory provision, it is exercising a power that belongs to Congress. The effect is the same as a GAAR: it has substituted its own subjective policy judgment for the legislative choices Congress made when it enacted and later limited the ESD.

Implications for taxpayers: what these cases mean and how to respond

The risk landscape: jurisdictional considerations

Liberty Global is binding precedent only for taxpayers within the Tenth Circuit (and for cases appealable there). For cases appealable outside the Tenth Circuit, the Tax Court is not bound by the Tenth Circuit's reasoning; nevertheless, other courts may treat this decision as persuasive, particularly on transaction-definition and purposive "unintended benefit" framing. Practically, the IRS will incorporate *Liberty Global* into its national ESD playbook (in fact it already has), citing it to argue that (i) literal compliance is not dispositive, (ii) integrated transactions should be tested as a whole, and (iii) section 7701(o) relevance is satisfied where the result can be characterized as producing an "unintended" benefit. And notwithstanding the Tax Court's clear confirmation of a relevance standard in *Patel*, the IRS has already begun their attempts to ignore or minimize such standard through advancing expansive, generic categories of cases in which the ESD applied to satisfy the relevance requirement.

Reliance on the Angel's List: basic business transactions are not per se exempt

Taxpayers frequently invoke the Angel's List's reference to "basic business transactions" as shorthand protection against application of the ESD. While the Angel's List remains part of the legislative history accompanying section 7701(o) — and has not

been expressly disavowed by any court — some courts do not view it as creating a categorical exemption from economic substance scrutiny. Whatever the "intent" of Congress, neither the statutory text nor post-codification case law endorses the view that transactions labeled "basic" are *per se* outside the doctrine's reach.

The Tenth Circuit in *Liberty Global* rejected the argument that including routine corporate steps — such as entity classification, capitalization, or internal reorganizations — within a broader integrated plan insulates the overall transaction from scrutiny under section 7701(o). The court emphasized that "Liberty Global, Inc. (LGI) cannot escape the application of § 7701(o) by including within its integrated structure steps that might, if standing alone, be considered basic business transactions."[xxv] Rather than engaging the Angel's List directly, the court effectively treated it as beside the point where routine steps are deployed in service of a tax-driven, integrated structure designed to obtain a benefit that the court believed wasn't "intended" by Congress.

By contrast, *Patel* reflects a more cautious approach. There, the Tax Court acknowledged that routine business decisions are often outside the ESD's historical scope, but only after conducting a transaction-specific relevance analysis grounded in statutory text. Importantly, *Patel* did not elevate the Angel's List into a freestanding safe harbor; instead, it treated the concept of "basic business transactions" as context for determining whether Congress intended the doctrine to apply in the first place.

Taken together, the cases suggest a nuanced role for the Angel's List. Courts have avoided rejecting it outright — particularly given its roots in the legislative history — but they have also declined to treat it as dispositive. The practical takeaway is that routine business transactions remain vulnerable when combined within "tax-motivated" transactions.

The relevance requirement as a first line of defense

For post-2010 years, the central practical lesson is straightforward: section 7701(o)'s relevance requirement should be treated as a true first step, not an afterthought. *Patel* confirms that relevance is a separate, antecedent question that must be resolved before the two-prong test is applied. Taxpayers should develop a factual and legal record supporting the position that the doctrine is not relevant to the transaction at issue.

That argument is especially strong where the taxpayer is applying an express, mechanical rule. If a taxpayer satisfies the literal conditions of a provision like section 743(b) and claims the mandated adjustment, relevance can be contested based on the nature of the provision itself. Historically, the doctrine targeted transactions that exploited gaps or ambiguities — not those that followed unambiguous statutory directions. Taxpayers should make that distinction early and explicitly.

Although not addressed in *Liberty Global* or other recent ESD cases, taxpayers should emphasize that the ESD is not relevant when the resulting tax benefit arises from compliance with a statute which is itself an independent anti-abuse or anti-avoidance test. When Congress has enacted a specific anti-abuse provision, courts should not apply the ESD to disturb the congressionally-determined outcome.[xxvi] For example, Congress enacted section 304 to prevent taxpayers from avoiding the redemption and distribution provisions of sections 301 through 303. As such, section 304 must apply to achieve the outcome Congress intended such that certain sales are treated as redemptions if both the target and acquiring corporation are controlled by a common group.[xxvii] The ESD is not a catchall provision that applies in every case and the relevance threshold serves to ensure that the Code applies to taxpayers as Congress intended.

The two-prong test as the back-end defense

In *Liberty Global*, because the taxpayer conceded that the steps in its transaction lacked any independent profit potential or non-tax purpose, the Tenth Circuit had no occasion to analyze the objective or subjective prongs of section 7701(o). Instead, the appellate decision hinges entirely on the threshold relevance issue, offering no additional guidance on how to apply the two-pronged test in practice.

By contrast, in *Patel*, once the Tax Court determined the doctrine was relevant, it fully engaged in the conjunctive two-prong analysis mandated by section 7701(o). The Tax Court's analysis, as the first detailed post-codification application of the merits test, underscores that the taxpayer must demonstrate both (i) objective potential for profit (apart from tax benefits) and (ii) a substantial non-tax business purpose for the transaction to withstand disallowance.

The upshot is that taxpayers now face heightened uncertainty. One appellate opinion (*Liberty Global*) essentially allows courts to skip directly to disallowing "unintended" tax outcomes without fleshing out the profit or purpose metrics, while *Patel* delineates an approach that requires relevance as an initial hurdle and the two-prong test proceeds only after clearing that hurdle. For taxpayers, this divergence requires addressing ESD challenges on two distinct fronts: (1) a front-end relevance defense based on statutory text and historical context, and (2) a back-end defense on the merits of the transaction's economic substance, in the event a court finds the doctrine relevant.

Conclusion

Section 7701(o) reflects a compromise. Congress strengthened the ESD by codifying a conjunctive merits test, but it also preserved a limiting principle by making "relevance" a threshold requirement grounded in pre-2010 law. That structure matters.

Without a meaningful relevance inquiry, the ESD becomes available whenever a court concludes — often in hindsight — that a taxpayer obtained a result that the court views as "unintended" (based on its own subjective notions of congressional "intent"), even if the transaction satisfies the statute's literal terms.

Patel properly treats relevance as an antecedent legal question tied to text, context, and historically recognized boundaries on the doctrine's use. *Liberty Global*, by contrast, risks collapsing relevance into the merits through a broadly purposive "unintended benefit" framing. If that approach spreads, the ESD will operate as a *de facto* GAAR — shifting from interpretation to judicially administered anti-abuse policymaking and diluting the separation-of-powers choices reflected in Congress's repeated preference for targeted statutory anti-abuse rules rather than giving an open-ended override to the IRS (if it even could).

For taxpayers, the immediate implication is practical as much as doctrinal. Transactions should be evaluated — and defended — on two sequential planes: first, whether section 7701(o) is relevant at all given the nature of the statute being applied (particularly where Congress prescribed mechanical outcomes); and also whether the transaction satisfies the objective and subjective prongs. Building a record on relevance early can narrow the dispute, cabin the ESD to its intended domain, and reduce the risk that a court substitutes a generalized "smell test" for the statutory framework Congress enacted. But being able to present the facts to prove that the transaction was driven by non-tax considerations is a core trial skill necessary to successfully convincing a court to properly apply the law.

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[i] *Gilbert v. Commissioner*, 248 F.2d 399, 411 (2d Cir. 1957) (Learned Hand, J. dissenting) ("Except in rare instances statutes are written in general terms and do not undertake to specify all the occasions that they are meant to cover; and their "interpretation" demands the projection of their expressed purpose, upon occasions, not present in the minds of those who enacted them."); *see also Chisholm v. Commissioner*, 79 F.2d 14, 15 (2d Cir. 1935) ("the purpose which counts is one which defeats or contradicts the apparent transaction, not the purpose to escape taxation").
[ii] *See, e.g.*, *ACM P'ship v. Commissioner*, 157 F.3d 231 (3d Cir. 1998) (conjunctive test); *Sochin v. Commissioner*, 843 F.2d 351 (9th Cir. 1988) (disjunctive test); *Coltec Indus., Inc. v. United States*, 454 F.3d 1340 (Fed. Cir. 2006) (unitary test).
[iii] Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, § 1409, 124 Stat. 1029, 1067–69 (codified at IRC § 7701(o)).
[iv] *See, e.g.*, *Gitlitz v. Commissioner*, 531 U.S. 206, 220 (2001) (holding that the Court "need not address" the policy concern that shareholders may experience a "double windfall" because "the Code's plain text permits the taxpayers here to receive these benefits".
[v] The Court's reviewed opinion, joined by a substantial majority of the bench, leaves little room for doubt that the relevancy determination is a genuine threshold inquiry and not merely a formality. The Court emphasized that the two conditions — relevancy and the two-prong test — are sequentially ordered and independently significant.
[vi] *Cf. Liberty Glob., Inc. v. United States*, No. 1:20-CV-03501-RBJ, 2023 WL 8062792 (D. Colo. Oct. 31, 2023).
[vii] *Patel*, 165 T.C. No. 17, at *22, n.14.

[viii] *Id.* at *19.
[ix] *Id.* at *22, n.16.
[x] *Liberty Glob. v. United States,* No. 23-1410 at *18 (10th Cir. Apr. 21, 2026).
[xi] In *Liberty Global*, the taxpayer expressly stipulated that the challenged transactions failed both prongs of section 7701(o)'s economic substance test. As a result, the only contested issue on appeal was whether the ESD was relevant to the transaction at all and how the "transaction" should be defined. In that posture, the Tenth Circuit had no occasion to conduct a separate two-prong analysis or to consider how the relevance inquiry should interact with the statutory merits test. The court's tendency to collapse relevance into a purposive assessment of "unintended" benefits may therefore reflect, at least in part, the absence of any need to analyze the two-prong inquiry independently – rather than a considered rejection of the analytical sequencing emphasized in *Patel*. That procedural posture distinguishes *Liberty Global* from cases in which relevance and economic substance are both live issues and may help explain the court's limited engagement with section 7701(o)'s structural separation between those inquiries.
[xii] *Liberty Glob.*, No. 23-1410, at *13.
[xiii] *Id.* at *16.
[xiv] *Id.*
[xv] *Liberty Glob.*, No. 23-1410, at *17.
[xvi] *Id.*
[xvii] *See West Virginia v. EPA*, 597 U.S. 697 (2022).
[xviii] *See, e.g.*, *J.W. Hampton, Jr., & Co. v. United States*, 276 U.S. 394, 409 (1928) ("Congress shall lay down by legislative act an intelligible principle to which the person or body authorized to [act] is directed to conform.").
[xix] *Liberty Glob.*, No. 23-1410, at *15, n.10.
[xx] *Horn v. Commissioner*, 968 F.2d at 1237-38 (characterizing the ESD as an aid to statutory interpretation that asks what Congress intended when it enacted the relevant provision, not as a freestanding rule permitting courts to override statutory text based on their own policy preferences).
[xxi] *See generally Loper Bright Enters. v. Raimondo*, 603 U.S. 369 (2024).
[xxii] *Liberty Glob.*, No. 23-1410, at *15, n.10.
[xxiii] *See* Joint Committee on Taxation, Technical Explanation of the Revenue Provisions of the "Reconciliation Act of 2010," as Amended, in Combination with the "Patient Protection and Affordable Care Act" 153 (Mar. 21, 2010) (noting that the enactment was intended to provide "greater certainty" and "consistent application" of the doctrine and that the relevancy requirement was intended to preserve pre-existing limitations on the doctrine's scope).
[xxiv] *Liberty Glob.*, No. 23-1410, at *29 (Eid, J. dissenting).
[xxv] *Id.* at *18.
[xxvi] *See Canaveral Int'l Corp. v. Commissioner*, 61 T.C. 520 (1974) (solely applying section 269(a) anti-abuse rule, not economic substance doctrine); *Trans City Life Ins. Co. v. Commissioner*, 106 T.C. 274 (1996) (solely applying section 845(b) anti-abuse rule).
[xxvii] *See Webb v. Commissioner*, 67 T.C. 293, 303 (1976) (acknowledging Congress closed loophole with section 304), *aff'd per curiam*, 572 F.2d 135 (5th Cir. 1978).