

# United States: Courts show changing attitudes towards anti-abuse doctrines

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Economic Substance Doctrine

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## In brief

Looking back at 2023, it is clear that the IRS has begun to increasingly assert anti-abuse doctrines, most notably the economic substance doctrine (ESD), in contentious tax controversies. Correspondingly, courts have had more opportunities to analyze and conceptualize the various anti-abuse doctrines. Courts in *Liberty Global*, *GSS Holdings*, and *Chemoil* have each offered unique and sometimes conflicting analyses in this regard. When reviewing these cases at a high level, a worrisome pattern emerges of courts conceiving of the traditional three anti-abuse doctrines as simply manifestations of a much broader substance over form tax principle. Further, despite the text of section 7701(o), courts are rejecting the idea that there exist certain transactions to which the ESD does not apply.

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## Liberty Global

Over the past few months, much ink has been spilt over *Liberty Global, Inc. v. Commissioner*, 1:20-cv-03501-RBJ (D. Colo. Oct. 31, 2023). There, the taxpayer engaged in a "gap-year" transaction to purposefully trigger gain that generated earnings and profits (E&P) that were not subject to GILTI but that qualified for the new section 245A dividends received deduction (DRD).

The Treasury and the IRS addressed these gap-year transactions by issuing regulations under Treas. Reg. 1.245A-5T (i.e., the "extraordinary disposition regulations") that would have disallowed a dividends received deduction for dividends generated from such transactions. The taxpayer, however, distributed E&P from a gap-year transaction before the Treasury and the IRS were able to promulgate those regulations. The court previously held that the extraordinary disposition regulations were invalid because the Treasury failed to satisfy pertinent notice-and-comment requirements under the

Administrative Procedure Act. Unable to attack the transaction under the regulations, the IRS claimed that the relevant transaction did not satisfy the ESD and that the court should disallow the taxpayer's section 245A DRD attributable to the E&P that had not been subject to US tax. On 31 October 2023, a US District Court in Colorado granted the DOJ's motion for summary judgment to disregard the tax benefits of the transaction under the ESD.

Many commentators have focused on the court's refusal to perform a separate relevancy threshold inquiry—despite a clear Congressional mandate to do so as provided in section 7701(o)(5)(C)—with the court instead stating that the ESD's relevance was "coextensive" with the ESD's two prongs. See Order On Cross-Mots For Summ. J. at 9, *Liberty Global, Inc., v. United States*, No. 1:20-cv-03501-RBJ (D. Colo. Oct. 31, 2023) ("At the risk of tautology, I proceed with the conclusion that the economic substance doctrine applies when a transaction lacks economic substance.").

Perhaps equally as interesting is the version of the ESD that the court applied. Although the *Liberty Global* court purported to and ostensibly did follow the two-prong analysis explicitly codified in section 7701(o), it is clear from a close reading of the opinion that the court instead adopted the so-called, pre-codification "unitary" conceptualization of the ESD. Under this older approach, implicitly rejected by Congress in its enactment of section 7701(o) and incompatible with the Supreme Court's decision in *Frank Lyon Co. v. United States*, 435 US 561 (1978), the ESD is conceptualized not as an anti-abuse doctrine separate and distinct from the substance over form doctrine, but instead as nothing more than one of many formulations of the broader idea of substance over form. Under the unitary analysis of the ESD, the two prongs are not applied separately, but rather collapse into an inquiry into whether the transactions in question had sufficient economic substance. To the extent that the two prongs matter, they are treated as two of many relevant factors in determining whether the transaction ought to be respected. The court in *Liberty Global* tipped its hand when it stated "[t]he economic substance doctrine is one variation of the common law doctrine of 'substance over form[.]'" Further, the court, quoting the unitary analysis case of *James v. Commissioner*, 899 F.2d 905, 908-09 (10th Cir. 1990), stated that the two prongs are simply "more precise factors to consider[.]"

## GSS Holdings

Another important ESD case was decided by the US Court of Appeals for the Federal Circuit. In *GSS Holdings (Liberty), Inc. v. United States*, 81 F.4th 1378 (Fed. Cir. 2023), the Federal Circuit helpfully confirmed that the ESD is a separate doctrine from the step transaction doctrine.

In that case, the taxpayer had acquired a note instrument, which was treated as an equity interest in a partnership, from a third party (the "Note Acquisition"). After the Note Acquisition, the taxpayer, directly and indirectly, owned all equity interests in the partnership for US tax purposes. A day later, the partnership satisfied the note instrument by transferring USD 24 million of cash to the partner that had just acquired the instrument, thereby triggering a USD 24 million ordinary loss at the partnership (the "Note Repayment"). At the same time, the partnership also sold USD 245 million of capital assets to the partner that had just acquired the instrument (the "Asset Transfer").

Originally, the taxpayer had filed a tax return that treated the USD 24 million Note Repayment as a purchase price reduction to the partnership's USD 245 million Asset Transfer. As a result, the partnership initially treated the combined Note Repayment and Asset Transfer as giving rise to a USD 24 million capital loss from the sale of assets that was disallowed under section 707(b). However, a couple of years later, the taxpayer filed an amended return that sought to treat the Note Repayment and Asset Transfer as separate transactions. If US tax laws treated the Note Repayment as a separate transaction, then the taxpayer claimed that the partnership was entitled to a USD 24 million ordinary loss.

The trial court disallowed the loss on the amended return under a hybrid step transaction and ESD analysis. As generally understood, under the ESD, only the step that generates the tax benefit in question is considered. In contrast, under the step transaction doctrine, courts look at all the individual steps of a transaction, including steps that did not create the relevant tax benefit, and decide whether to collapse these steps into one. Yet, instead of doing one analysis or the other, the trial court relied on ESD principles to analyze only one step of the transaction (i.e., the step generating the tax benefit) and then confusingly applied the step transaction doctrine to combine several transactions into a single step. Specifically, the court found that the taxpayer's Note Repayment was the step that gave rise to the tax benefit and then disallowed the taxpayer's loss under the step transaction doctrine by seemingly combining the Note Repayment and Asset Sale. On appeal, the taxpayer argued that the lower court impermissibly conflated the step transaction doctrine with the ESD and consequently improperly applied a hybrid legal standard.

The Federal Circuit's majority opinion in *GSS Holdings* agreed with the taxpayer and affirmed the separate existence of the ESD and the step transaction doctrine. The majority noted that the step transaction doctrine is a doctrine that operates by collapsing the individual steps of a complex transaction into a single transaction. In contrast, the ESD is a doctrine that disallows certain tax benefits by disregarding the transactions that created them.

Notably, however, the dissenting opinion in *GSS Holdings* disagreed with the separateness of the two doctrines. Instead, the dissent adopted the outdated approach (also found in *Liberty Global*) under which there is simply one substance over form analysis, and the step transaction doctrine or the ESD are nothing more than "manifestation[s] of the more general tax law ideal that effect should be given to the substance, rather than the form, of a transaction[.]" See *GSS Holdings*, 81 F.4th at 1385 (quoting *Falconwood Corp. v. United States*, 422 F.3d 1339, 1349 (Fed. Cir. 2005)).

## Chemoil

In *Chemoil Corp. v. United States*, No. 19-CV-6314-LTS-JW, 2023 US Dist. LEXIS 171675 (S.D.N.Y. 26 September 2023), the US District Court for the Southern District of New York applied the ESD to deny the taxpayer a tax refund based on alcohol fuel mixture tax credits. The taxpayer, in contrast, argued that the ESD did not apply to certain transactions, including transactions resulting in tax credits that fall within the scope of the type of activity that the credit was intended to incentivize. According to the taxpayer, the ESD did not apply to transactions in which "a taxpayer makes the type of investment or undertakes the type of activity that the credit was intended to encourage."

The court was unpersuaded by this line of reasoning, finding support in Second Circuit case law stating that there are no "categorical exceptions" to the ESD, and determined that transactions entered into with the purpose of obtaining tax credits meant to encourage those exact transactions fall within the gamut of the ESD. Although the court in *Chemoil* did not address the issue of relevancy, it could possibly be inferred that a lack of "categorical exceptions" necessarily implies universal relevancy—something the court in *Liberty Global* also found, but which is expressly denied by a plain reading of section 7701(o).

## Implications

Traditionally, courts have recognized three canonical anti-abuse doctrines: ESD, step transaction, and substance over form. However, based on *Liberty Global* and the dissent in *GSS Holdings*, courts are increasingly beginning to recognize the anti-abuse doctrines not as three separate doctrines, but instead as simply manifestations of one, broad substance over form principle. This approach partially reflects the dearth of post-codification case law interpreting the ESD, with many of the pre-codification cases applying the ESD in a way that contradicts section 7701(o).

Additionally, courts are beginning to either outright reject a separate relevancy threshold inquiry before applying the ESD, or are finding the ESD to be applicable without exception.

## Contact Information

### John Barlow

Partner

Washington, DC

[Read my Bio](#)

[john.barlow@bakermckenzie.com](mailto:john.barlow@bakermckenzie.com)

### Vivek Patel

Partner

Washington, DC

[Read my Bio](#)

[vivek.patel@bakermckenzie.com](mailto:vivek.patel@bakermckenzie.com)

### David Brotz

Associate

Chicago

[Read my Bio](#)

[david.brotz@bakermckenzie.com](mailto:david.brotz@bakermckenzie.com)

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