

Federal District Court Rules Codified Economic Substance Doctrine Vitiates Tax Transaction Benefits

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On October 31, 2023, the US District Court for the District of Colorado, in *Liberty Global, Inc. v. United States*, applied the codified economic substance doctrine and held—on summary judgment—that Liberty Global, Inc. (LGI) must recognize \$2.4 billion in taxable gain. At issue was a four-step transaction that took place in 2018, as a result of which LGI took the position that a dividends received deduction offset a \$2.4 billion taxable gain based on a purported “mismatch” between (1) the rules for taxation of global intangible low-taxed income (GILTI) or subpart F income of a controlled foreign corporation (CFC) and (2) the qualification of an entity as a CFC.

In rejecting what it described as LGI’s “scheme” to “exploit” the apparent mismatch, the Court made three preliminary holdings. First, LGI argued that the prefatory clause in Internal Revenue Code (IRC) section 7701(o)—“[i]n the case of any transaction to which the economic substance doctrine is *relevant*”—requires courts to conduct a threshold analysis into whether the economic substance doctrine is “relevant” to the transaction at issue, and only then can courts consider whether the transaction has “economic substance.” The Court rejected this

argument, stating that “there is no threshold ‘relevance’ inquiry that precedes the inquiry” into a transaction’s economic substance. Instead, “the doctrine’s relevance is coextensive with the statute’s test for economic substance.” Second, the Court held that the proper unit of analysis is “the transaction in aggregate” and did not analyze any step or phase in isolation, even if it could be said that the tax benefit at issue was “created” because of a particular step. And third, the Court denied LGI’s contention that its transaction falls under any exception to the economic substance doctrine. The Court determined that LGI’s transaction was not a “basic business transaction” and, although a series of transactions that constitute a corporate organization or reorganization might fall outside the economic substance doctrine, a series of transactions that merely includes a reorganization is not necessarily exempt.

The Court then applied the economic substance doctrine. LGI conceded that steps one through three “did not change, in a meaningful way, LGI’s economic position,” so the Court considered whether the steps had a substantial, non-tax purpose. LGI asserted that the transaction was “in furtherance” of Belgian corporate law requirements, but the Court found LGI had failed to indicate how the transaction facilitated such compliance. Moreover, an action may be “in furtherance” of some end without being a “substantial purpose” of the action, as IRC Section 7701(o) requires. Even if an isolated step provided substantial, non-tax benefits for LGI, that does not suggest the existence of a non-tax purpose for “the entire scheme.” Thus, the Court held that “the only substantial purpose of the transaction was tax evasion.”

The Court concluded that steps one through three of the transaction must be disregarded under federal law, resulting in \$2.4 billion of taxable gain on LGI’s sale of its subsidiary during step four without such gain being converted to a dividend and sheltered by a dividends received deduction.

Practice Point: *Liberty Global* is a potentially significant development for taxpayers engaging in multistep transactions. Although we are still analyzing the case and its ramifications, the Court's application of the economic substance doctrine, if not reversed or limited on appeal, may lead to further challenges by the Internal Revenue Service.

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