

CLIENT ALERT

THE EXPANDING ECONOMIC SUBSTANCE DOCTRINE: TIME TO STRESS-TEST YOUR ENTITY AND TRUST PLANNING

A recent federal appeals court decision, *Liberty Global, Inc. v. United States*, is a pointed reminder that technical compliance with the Tax Code does not shield a transaction from challenge—the substance of the entire plan, not just its individual steps, must hold up. Below we summarize the decision and what it means for the entity and trust structures we design for closely held businesses and families.

The Doctrine

The economic substance doctrine is a long-standing anti-abuse principle—now codified at Internal Revenue Code § 7701(o)—that denies tax benefits to transactions “to which the economic substance doctrine is *relevant*,” (emphasis added) unless the transaction: (i) meaningfully change the taxpayer's economic position apart from its tax effects and (ii) is undertaken for a substantial non-tax and/or legitimate business purpose. In other words, a deal must have real-world consequences beyond the tax savings it generates; technical compliance with the Code alone is not enough.

The Decision

In *Liberty Global, Inc. v. United States* (10th Cir. Apr. 21, 2026), a divided federal appeals court held that IRC § 7701(o)'s economic substance doctrine applied to “Project Soy,” a multi-step plan that a telecommunications company used to claim a \$2.4 billion income tax deduction by exploiting a timing gap in the 2017 Tax Cuts and Jobs Act. Over a four-day period in December 2018, the company manufactured billions of dollars of earnings inside a foreign subsidiary through internal moves—capital reductions, an entity conversion, a “check-the-box” election, and debt-like instruments—and then sold the subsidiary so that the resulting gain could be sheltered.

The company conceded that those steps made no meaningful change to its economic position and served no substantial non-tax purpose, but argued that the doctrine was simply not “relevant” to a plan that complied with the letter of the Code. In particular, the company argued that certain steps of “Project Soy” were exempt as “basic business transactions” (e.g., corporate organization and entity selection) that it claimed Congress, in its deliberations on the statute, had identified as inherently legitimate. Accordingly, although the company admitted that steps one through three of Project Soy's four-step sequence had no substantial business purpose or economic effect, it claimed that the doctrine was not “relevant” to those basic transactions. The court found that: (i) there are no express exemptions found in the text of § 7701(o); and (ii) even if basic business transactions were exempt, the doctrine should be applied to the *entirety* of the transaction, not its individual components. Since the company had admitted that steps one through three would not have been taken except in contemplation of step four (the step that produced the gain and thereby the true tax benefit), the court concluded that, Project Soy's steps being “so integrated,” it could not find the doctrine inapplicable to a deliberate tax avoidance scheme simply because the component transactions might be legitimate on their own.

Ultimately, the court disagreed with the company's position and disallowed the deduction.

Why It Matters

The court's message is blunt: literal, mechanical compliance with the Tax Code is *not* a safe harbor and the entirety of a transaction (intermediate steps and all) must have economic substance or a legitimate business purpose outside of tax benefits. Two features of the ruling matter most for planning:

- **The whole plan is the unit of analysis.** The statute treats a “series of transactions” as a single transaction, so the government may collapse a multi-step plan and test the integrated whole rather than each step in isolation.
- **“Basic” building blocks do not legitimize a tax-driven plan.** Folding ordinary steps—entity formations, capitalization choices—into a structure whose only real effect is a tax benefit does not protect the structure. The court did not hold that those ordinary steps are vulnerable standing alone, and the panel split 2–1 on how strong the “relevance” requirement should be—with the majority notably according the requirement very little weight.¹

None of this is new law. The economic substance doctrine and the arguments behind it have long been available to the IRS; *Liberty Global* reaffirms them. The decision is best read as a signal that these established principles may be applied more assertively, not as a change in the underlying rules that should upend sound planning.

Impact on Entity and Trust Planning

Liberty Global involved cross-border corporate income tax provisions, but IRC § 7701(o) is generally applicable to all taxpayers, and its reasoning reaches the multi-entity and trust structures we routinely design for closely held businesses and families engaged in advanced estate planning. Much of that planning is intentionally sequential—form an entity, capitalize it, transfer assets, then sell or gift interests to a trust—and the decision confirms that such steps will be examined together. The codified doctrine expressly applies to the subtitle of the Internal Revenue Code governing *income tax* (subtitle A), so it bears most directly on the income-tax features of a plan. In contrast, pure *estate* and *gift* tax strategies are governed by its common-law cousins (substance-over-form, step-transaction, and Code § 2036), which reflect the same principle. The decision binds only the Tenth Circuit—California sits in the Ninth, making it persuasive rather than controlling here. However, this case reflects the position the IRS is taking nationwide—meaning the IRS may apply greater scrutiny to multi-step transactions in the future.

The Penalty Stakes

The cost of getting this wrong is severe and largely cannot be cured by a tax opinion:

- **Federal:** a 20% penalty on the underpayment, doubling to 40% if the transaction was not adequately disclosed—and it is *strict liability*, so reasonable-cause and good-faith defenses (including reliance on a tax opinion) do not apply.
- **California:** a parallel 40% “noneconomic substance transaction” penalty under Revenue & Taxation Code § 19774 (reduced to 20% with adequate disclosure), which conforms to the federal doctrine and turns on whether the taxpayer had a valid non-tax California business purpose.

What to Do Now

We recommend reviewing existing and contemplated structures with these principles in mind:

- **Document a genuine non-tax purpose** for every entity and trust, such as succession, liability and asset protection, creditor protection, bonding or licensing needs, management, or family governance.
- **Make sure there is a real change** in economic risk, control, or beneficial enjoyment, with entities adequately funded and their formalities respected over time.
- **Avoid compressed, circular steps** executed in a short window solely to reach a tax result.
- **Weigh disclosure deliberately**, as it is the principal way to cut both the federal and California penalties in half, and belongs in the planning conversation, not the return-preparation afterthought.

Because *Liberty Global* reaffirms existing principles rather than creating new ones, it does not signal the end of legitimate, tax-efficient planning. The Tax Code is full of structures and incentives Congress intended taxpayers

to use. But it does call for discipline: real substance, a genuine non-tax purpose, and a contemporaneous record. Please contact our office to review your business entity and trust structures and confirm their effectiveness following *Liberty Global*.

¹ The text of IRC § 7701(o)(5)(C)—“[t]he determination of whether the economic substance doctrine is relevant to a transaction shall be made in the same manner as if [IRC § 7701(o)] had never been enacted”—suggests that, as a threshold requirement, the court must determine that the economic substance doctrine applies based on existing case law precedents independent of IRC § 7701. See *Patel v. Commissioner*, 165 T.C. No. 10 (Nov. 12, 2025) (noting that the legislative history confirms that IRC § 7701 “does not change current law standards in determining when to utilize an economic substance analysis,” H.R. Rep. No. 111-443(I), at 293-95 (2010), holding that IRC § 7701(o) requires a threshold relevancy determination that is “not coextensive” with the two-prong test, and sustaining the 40% penalty). Notably, the 10th Circuit in *Liberty Global* did not regard such a determination as a separate requirement, appearing instead to assert that the economic substance doctrine is necessarily relevant in all cases where the core statutory test applies: “[t]he economic substance doctrine . . . is relevant . . . to attempts by taxpayers to mechanically utilize the provisions of the Tax Code to obtain a benefit not intended by Congress.” The concern for taxpayers is that, although the inclusion of the relevancy determination in IRC § 7701(o) indicates that Congress did not intend to *expand* the application of the economic substance doctrine—but rather to facilitate its enforcement—the 10th Circuit has seemingly brushed aside a test designed to prevent expansion, potentially opening the door to relatively broader application moving forward.

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