District Court Applies Section 7701(o) in *Liberty Global*, But Did It Misstate the Law?

Richard M. Lipton

The court's conclusion that there is no separate inquiry into the "relevance" of the ESD in connection with the application of Section 7701(o) is simply inconsistent with both the statutory language and the legislative history of that provision.

In a recent decision, the District Court in Colorado concluded that a transaction entered into by Liberty Global, Inc. (LGI) lacked economic substance. The court that reached this conclusion was the same one that had previously concluded that the temporary regulations issued under Section 245A were invalid and could not be used to prevent the tax benefit claimed by LGI. However, the court has now disallowed the claimed benefits without regard to the regulations, i.e., the court concluded that LGI could not receive the tax benefits of the transaction it entered into due to the economic substance doctrine (ESD).

The court's analysis is set forth below. However, it is clear that the court misstated how Section 7701(o), which "codified" the ESD, operates. Specifically, the court ignored the plain language in Section 7701(o) and determined that it did not need to conclude that the ESD was "relevant" to a transaction in order to apply Section 7701(o), notwithstanding that the specific language of that provision requires such a determination. The court arguably made other errors in applying Section 7701(o), and LGI has already filed a notice of appeal.

BACKGROUND

LGI is a multinational telecommunications company. LGI was advised on tax matters by Deloitte, LLC. In June 2018, Deloitte approached LGI about a perceived opportunity in the international tax provisions of the 2017 Tax Cuts and Jobs Act, Pub. L. No. 115-97, 131 Stat. 2054 (TCJA). This opportunity arose due to "mismatch" (as LGI's tax professionals called it) 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. In short, a foreign corporation not directly owned by any U.S. person might qualify as a CFC for U.S. tax purposes because ownership may be "attributed" to a U.S. person, but only CFCs with an actual U.S. shareholder on the last day of the taxable year are subject to GILTI or Subpart F.

With Deloitte's assistance, LGI planned a four-step series of transactions, code-named "Project Soy," which was specifically designed to take advantage of the TCJA's "mismatch." Project Soy would allow LGI to avoid GILTI and capital gain taxes on billions of dollars of unrealized gain from LGI's interest in one of its sub-entities. The transaction was designed to generate enough artificial earnings and profits (E&P) — which, but for the mismatch, would have been taxed under subpart F or GILTI — to offset LGI's taxable gain on Step 4 of the plan, "the TGH Transaction."[1] In the TGH transaction, which occurred in December 2018, an LGI affiliate sold its interest in Telenet Group Holding (TGH), a Belgian company, to LGI's parent company, Liberty Global (based in the UK). The income from the TGH transaction is the income at issue in the court's decision.

Under the relevant tax laws at the time, LGI was required to recognize income equal to its share of gain from the TGH transaction. It sought to deduct that income using § 245A of the TCJA. In June 2019, Treasury issued temporary regulations addressing the international tax changes made by the TCJA. LGI filed a consolidated federal income tax return for its 2018 tax year on October 11, 2019, then filed an amended return on December 23, 2019. The initial return reported the fourth step of Project Soy in a manner that was consistent with the temporary Treasury regulations. The amended return adopted the position that the regulations were invalid and claimed a refund of $95,783,237 as a result.

LGI claims that it met the requirements to receive the § 245A deduction for the TGH transaction. However, because the temporary regulations, adopted in June 2019, were made retroactive, LGI did not receive the full deduction. After LGI filed its amended return claiming a federal income tax refund, the IRS began to review LGI's Project Soy transactions. LGI produced some, but not all, of the information requested. On November 19, 2020 the IRS issued a delinquency notice to LGI regarding the missing information and included a deadline of November 27, 2020 to respond to the notice before the IRS might seek to issue and enforce a formal summons for the information in a federal court proceeding.

On November 27, 2020, LGI filed a complaint in federal district court seeking a refund of approximately $110 million that it alleges to have overpaid for its 2018 year. Because it still had not provided the information sought by the IRS, the United States answered that discovery was necessary to determine the extent of LGI's earnings and profits and the nature of the transactions.

On April 4, 2022, the Court granted in part LGI's motion for summary judgment, concluding that the 2019 temporary Treasury regulations did not comply with the requirements of the Administrative Procedure Act and therefore did not have valid retroactive effect over the transactions occurring in LGI's 2018 tax year, but denying the motion "to the extent that factual questions remain on LGI's compliance with

Richard M. Lipton, Senior Counsel, Baker McKenzie, Dallas, Texas, richard.lipton@bakermckenzie.com. Thank you to Samuel P. Grilli from Baker McKenzie for his helpful comments.

 © 2024 Thomson Reuters

the underlying tax laws in the TGH transactions." *Liberty Global, Inc. v. United States*, No. 1:20-cv-03501-RBJ, 2022 WL 1001568, at *7 (D. Colo. April 4, 2022).

The United States contended that LGI is not entitled to the tax refund that it sought because the economic substance doctrine (or alternatively, the step transaction doctrine) dictates that Steps 1-3 of Project Soy should be disregarded when calculating LGI's tax obligations. LGI argued that neither doctrine should apply, and therefore, that the E&P generating steps, which permitted the § 245A deduction for the TGH transaction, should be given effect. Both parties asserted that the facts relevant to the analysis of whether and how the economic substance doctrine applies are not contested.

THE COURT'S ANALYSIS

The court concluded that it could resolve this matter by reference solely to the ESD, and as a result, it did not consider whether the transaction entered into by LGI could be challenged under the step transaction doctrine.

As the court stated, the ESD is one variation of the common law doctrine of "substance over form," which instructs courts to effectuate the "plain intent of the relevant statutory regime" — in this case, the tax code — by viewing transactions in terms of their "objective economic realities" rather than their technical compliance with statutory requirements. *See Frank Lyon Co. v. United States*, 435 U.S. 561, 573 (1978) (concluding that the ESD did not apply to a sale-and-leaseback transaction by looking "to the objective economic realities of a transaction rather than to the particular form the parties employed"). In the tax context, the doctrine permits courts to ignore transactions that are "mere device[s]" for tax avoidance. *See Gregory v. Helvering*, 293 U.S. 465, 468-70 (1935) (refusing to give effect to a corporate reorganization that "technically complied" with statutory requirements but that the Court found had "no business or corporate purpose" other than to transfer corporate shares to the petitioner).

The doctrine was codified in 2010 in 26 U.S.C. § 7701(o), which provides in relevant part that "[i]n 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 legislative history of § 7701(o) clarifies that the doctrine "involves a conjunctive analysis." H.R. Rep. 111-443 at 297. In other words, for a transaction to have economic substance under the ESD, the transaction must satisfy both prongs of the statutory test—the transaction "must change in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and the taxpayer must have a substantial non-Federal-income-tax purpose for entering into such transaction." *Id.* This clarification in the House Report was intended to "eliminate[] the disparity" in application of the doctrine between federal circuit courts that applied the test conjunctively and courts that applied the test disjunctively. *See id.*

The court recognized that application of the ESD requires resolution of several issues: (1) whether the doctrine is "relevant" to this set of facts within the meaning of the statute's prefatory clause; (2) the appropriate level of granularity to be used in selecting the transaction or set of transactions to be analyzed; (3) whether any exemptions exist, and if so, whether they apply; and (4) whether the conjunctive test — the transaction had no meaningful non-tax effect and the taxpayer had no subjective non-tax purpose —is satisfied.

RELEVANCE OF THE DOCTRINE

LGI argued first that the prefatory clause in § 7701(o)—"[i]n the case of any transaction to which the economic substance doctrine is relevant" — should be distinguished from the operative clause — "a transaction is disregarded for tax purposes unless ... [it meaningfully changes the taxpayer's non-tax economic position and was conducted with a substantial non-tax purpose]" — and given independent effect. LGI viewed the prefatory clause as an instruction to conduct a threshold analysis into whether the doctrine is "relevant" to the transaction at issue, and then only if the threshold is met, to continue into the two-pronged inquiry set out in the operative clause of the statute.

LGI relied on a House Report for the proposition that the legislative intent was to explicitly limit the types of transactions to which the ESD would be "relevant" (citing H.R. Rep. No. 111-443, 296 (2010). However, the court concluded, contrary to the literal terms of the Code, that the House Report emphasizes that "the economic substance doctrine *becomes applicable,* and a judicial remedy is warranted, where a taxpayer seeks to claim tax benefits, unintended by Congress, by means of transactions that serve no economic purpose other than tax savings." H.R. Rep. No 111-443, 292 (citing *ACM P'ship v. Comm'r*, 157 F.3d 231 (3d Cir. 1998), aff'd 73 T.C.M. (CCH) 2189 (1997), cert, denied 526 U.S. 1017 (1999)) (emphasis added). According to the court, the ordinary meaning of the report's statement that the doctrine "becomes applicable" under certain circumstances strongly suggests that the doctrine is "relevant" within the meaning of the statute under the same circumstances. This statement in turn suggests that the doctrine's relevance is coextensive with the statute's test for economic substance, provided by the operative clause.

The Court further stated that there is no threshold "relevance" inquiry that precedes the inquiry described in the operative clause, and that this conclusion is consistent with the interpretations of the Supreme Court and courts in the Tenth Circuit. *See, e.g., Blum v. Comm'r*, 737 F.3d 1303, 1309 (10th Cir. 2013) (citing *Jackson v. Comm'r*, 966 F.2d 598, 601 (10th Cir. 1992)) (describing the "doctrinal framework" of the ESD as "fairly straightforward" and instructing courts to "ask two questions: (1) what was the taxpayer's "subjective business motivation," and (2) did the transaction have objective economic substance?"). The Tenth Circuit there conspicuously omitted any mention of a threshold inquiry or a separate or additional question that courts must resolve in applying the ESD, simply asking two questions: (1) what was the taxpayer's "subjective business motivation," and (2) did the transaction have objective economic substance?".

Instead, the court stated that the ultimate inquiry into economic substance is asking whether a transaction's benefits violate the legislative intent. *See, e.g., Gregory*, 293 U.S. at 467 (disregarding a corporation's "so-called reorganization" because it

© 2024 Thomson Reuters

"was nothing more than a contrivance" to avoid taxes, and therefore lay "outside the plain intent of the statute"). Certain circumstances raise "red flags" that a transaction lacks economic substance and correspondingly violates Congress's intent, "such as 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.'" *Blum*, 737 F.3d at 1310 (quoting *James*, 899 F.2d at 908).

The court stated that the "relevance" of the ESD was not an issue because the two prongs enumerated in § 7701(o) reflect in the most inclusive terms the situations that violate congressional intent for lack of economic substance: when a taxpayer intentionally enters a transaction that serves no purpose other than tax evasion with the sole purpose of avoiding taxes.

According to the court, the ESD applies when a transaction lacks economic substance, i.e., the economic substance doctrine applies when it applies, and there is no question under Section 7701(o) whether or not the doctrine is "relevant" with respect to a specific transaction. The question of whether a transaction lacks economic substance is equivalent to the question of whether the tax benefits achieved in the transaction violate congressional intent and is analyzed using the enumerated statutory prongs which are in turn elaborated and informed by the "red flags" that courts have long described. *See Blum,* 737 F.3d at 1310 (quoting *James*, 899 F.2d at 908-09) (emphasizing that the "two [statutory] factors, rather than being independent prerequisites to finding an absence of economic substance, are simply 'more precise factors to consider' in that analysis"). There is no "threshold" inquiry separate from the statutory factors.

UNIT OF ANALYSIS

The next question addressed by the court was whether, as LGI argued, the Court's analysis should isolate Step 3 of Project Soy — the "entity conversion" in which Telenet Group converted from a BVBA to an NV under Belgian law[2] —or whether, as the government argued, the analysis should consider the steps of Project Soy collectively.

The transaction to be examined in an economic substance doctrine analysis is "the transaction that gave rise to the alleged tax benefit." *Sala,* 613 F.3d at 1252 (citing *Coltec Indus., Inc. v. United States*, 454 F.3d 1340, 1356 (Fed. Cir. 2006)). LGI argued that, because the tax benefit at issue —"the generation of E&P" — was "created by the Entity Conversion" at Step 3 of Project Soy, that step in isolation "is the transaction to be examined." This court disagreed.

First, Step 3 was not the only step in the transaction that generated E&P — Step 2 also generated "springing to life debt" that created E&P. Second, generating E&P is not itself a tax benefit. It is a component required to take advantage of the "mismatch" that caused the benefit – in which "a corporation might claim CFC status, [and] yet have no U.S. shareholders to pay GILTI and subpart F tax at year-end." The generation of "artificial E&P" that could be used to offset the taxable gain on the TGH transaction was economically feasible for LGI only because of the mismatch. Per the court, creation of the mismatch would not have produced a tax benefit without the generation of E&P, and generation of E&P would not have produced a tax benefit without also establishing the mismatch. To treat a *necessary* step of the transaction as *sufficient* to produce the transaction's full effect, as LGI proposed, would be logically unsound, according to the court.

Moreover, the court stated that to artificially isolate Step 3 from the remainder of the overall transaction would contravene the legislative intent of § 7701(o), which was for courts to conduct "necessarily flexible" analyses to effectuate the tax rules. *Blum,* 737 F.3d at 1311; *see also* H.R. Rep 111-443 at 295 (noting that "a strictly rule-based tax system" cannot prevent all unintended consequences and that courts may therefore "supplement tax rules with anti-tax-avoidance standards, such as the economic substance doctrine, *in order to assure the Congressional purpose is achieved*") (emphasis added). Congress emphasized that courts may "aggregate, disaggregate, or otherwise recharacterize a transaction when applying the doctrine" to effectuate that purpose. H.R. Rep. 11-443 at 297.

In *Sala*, the Tenth Circuit held that the district court had erred in including in the economic substance analysis a later segment of Sala's participation in the "Deerhurst Program," when the "only transaction that relate[d] to the $60 million tax loss Sala [sought] to claim" was an earlier segment of participation in the program that had "no connection" to the later segment, there was "a clear break between each phase," and the later phase "had no tax benefits." 613 F.3d at 1252. Here, by contrast, the court concluded that it is appropriate to aggregate the entity conversion step of Project Soy with the other steps of the transaction. Unlike the taxpayer's participation in two phases of the Deerhurst Program in *Sala*, only one of which produced the asserted tax benefit, Steps 1 through 3 here each "related" to the tax benefit that LGI sought to claim, since each was a component of the carefully choreographed creation of the TCJA mismatch. Far from having "no connection" to one another or being divided by "clear break[s]" in time between phases, as in *Sala*, the steps of Project Soy were executed in a four-day period in December 2018 and were "so integrated" that LGI admitted that it is "unlikely that Steps 1, 2, and 3 would have been taken except in contemplation of the TGH transaction in Step 4."

Just as the Second Circuit in *Bank of New York Mellon Corp. v. Commissioner* affirmed the district court's authority there to *segregate* "a routine transaction [from] a transaction lacking economic substance" to avoid stymieing the doctrine's purposive application by an arid formalism, 801 F.3d 104, 121 (2d Cir. 2015), the court stated that it may use its authority to *aggregate* interrelated transactions to likewise avoid frustrating the doctrine's purpose. Therefore, the Court rejected LGI's invitation to conduct the economic substance analysis with a narrow focus on Step 3 of Project Soy, and instead considered whether Steps 1, 2, and 3 together should be recognized for tax purposes (affording LGI the claimed deduction) or disregarded for lack of economic substance.

Having concluded that it did not need to determine whether or not the ESD was "relevant" to the transaction and that it could look at all of the steps in Project Soy in applying the ESD, the court turned to whether the transaction at issue is exempted from the economic substance doctrine either explicitly or by analogy to statutorily enumerated exceptions. LGI argued first by analogy to certain permissible tax-motivated decisions that this business transaction must necessarily fall

© 2024 Thomson Reuters

outside the scope of § 7701(o), e.g., in some cases, the tax consequences of a transaction are intended to be respected even where the transaction only has tax effects and citing as an example that married couples can elect to file a joint tax return or separate tax returns each year — a purely tax-motivated decision that affects the couple's tax but is nonetheless respected.

The court rejected this argument. The ESD applies to "*transactions* that have no business purpose or economic substance beyond tax evasion." *Schussel v. Werfel*, 758 F.3d 82, 97 (1st Cir. 2014) (emphasis added); see also *Blum*, 737 F.3d at 1309 (introducing its discussion of the economic substance test by asking "how, exactly, should a court determine whether a *transaction* possessed objective economic substance?") (emphasis added). Filing taxes — jointly or individually —is not a "transaction." Moreover, because filing taxes jointly with one's spouse for a tax advantage does not "upon its face lie[] outside the plain intent" of the tax code, it does not implicate the core purpose of the ESD to prevent business organizations from entering schemes to evade taxes under circumstances in which Congress would have intended that the laws apply.[3] *See Gregory*, 293 U.S. at 470. In contrast to the situation in *Gregory* — in which the Court disregarded a corporate reorganization that was a "mere device," because the new corporation, although validly created, was "nothing more than a contrivance" for tax evasion — there is typically no suggestion that a person's marital status is a mere device or contrivance intended solely or primarily for tax benefits. According to the court, the transactions entered into by LGI violated congressional intent. The court concluded that Project Soy was designed to, and does, unlink the § 245A deduction from the "appropriate anti-base erosion safeguards" that the legislature intended.

The taxpayer's related argument that Project Soy is one of the "basic business transactions" that the legislature intended to exempt from application of the economic substance doctrine likewise failed. See H.R. Rep. No. 111-443 at 296, noting that "the ESD does not apply to '*basic business transactions* that, under longstanding judicial administrative practice are respected, merely because the choice between meaningful economic alternatives is largely or entirely based on comparative tax advantages'"). The transaction at issue here was not merely the entity conversion that Telenet Group underwent at Step 3, but rather the full choreography of sub-transactions that occurred in Steps 1 through 3. The court stated that it was absurd to imagine that Deloitte would be consulted to devise and carry out a "basic business transaction" within any ordinary or comprehensible use of the phrase, and no reasonable factfinder could characterize Project Soy as such.

LGI argued alternatively that because the entity conversion fits within the exception for "organizations of a corporate entity" enumerated in the committee report, the series of transactions falls outside the scope of the economic substance doctrine (citing H.R. Rep. 111-443 at 296). The court stated that this argument is flawed in several respects. First, the statute contains no express exceptions, and the list of "exemptions" to which LGI refers appear only in the committee report as illustrations of the broader concept of "basic business transactions."[4] Furthermore, Project Soy is not a "basic business transaction," and therefore, that exception does not apply.

Second, the committee report states that "a transaction or series of transactions that *constitute* a corporate organization or reorganization" might represent the type of basic transaction exempt from application of the doctrine. H.R. Rep. 111-443 at 296. The report does not state or imply that any transaction that merely *includes* a reorganization is likewise exempt. There 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.

Third, precedent suggests that exceptions are construed narrowly and given limited effect when they would contravene effectuation of the doctrine's purpose. *See, e.g., Gregory,* 293 U.S. at 470 (disregarding under the economic substance doctrine a corporate reorganization, notwithstanding that the transaction itself constituted the type of "corporate organization" identified by the legislature in the committee report as an example of an exception). Here, at most two sub-transactions of Project Soy relate to a corporate reorganization (the transfer of subsidiaries and the entity conversion), as opposed to the entire transaction in *Gregory*. Furthermore, here, the explicitly admitted tax motivations of the scheme implicate the economic substance doctrine at least as strongly as did those in *Gregory*. The legislature's "basic business transaction" exception does not preclude application of the ESD. *See* 293 U.S. at 470. None of the examples of transactions suggested in the committee report as meriting respect notwithstanding their tax motivations or consequences applies here, since Project Soy was not merely a simple business operation but rather a coordinated series of simpler steps (as most complex transactions are). To apply the exemption for "basic business transactions" here would allow the exception to swallow the rule.

The court then applied the two-prong test in Section 7701(o) to Project Soy. LGI had made multiple admissions that effectively answered all of the questions.

On the first prong, LGI admitted that each of Steps 1 through 3 "did not change, in a meaningful way, LGI's economic position." LGI did qualify those responses by noting that Steps 1 through 3 each "had non-tax consequences, including consequences under Belgian corporate law." The court stated that the specific admission as to the first prong controls over the gesture to unenumerated and unexplained "consequences." If none of the steps in isolation meaningfully changed LGI's position, and since LGI provided no basis to infer that the steps cohered toward a broader, non-tax-related effect, it follows that those steps in aggregate (the focus of the court's analysis) did not change LGI's position in a meaningful, non-tax-related way. Thus, there is no genuine dispute of fact as to the first statutory prong.

On the second prong, LGI admitted that each of Steps 1 through 3 "served no substantial non-tax purpose for LGI." The fact that LGI "did not direct Telenet Group Holding to enter into" the transaction makes no difference in this analysis. Project Soy was coordinated among LGI, Telenet, and TGH. Therefore, it is appropriate to consider LGI's intent as to the effect of the transaction, even if it did not formally execute every step but rather merely orchestrated and facilitated the process.

LGI in its brief asserted that compliance with "Belgian corporate law requirements" was a substantial non-tax purpose for Steps 1 through 3 of Project Soy, within

the meaning of the second prong. But the court rejected this argument, too. First, LGI provided no indication what the Belgian law was or how the entity conversion, the issuance of profit certificates, or the restructuring of subsidiary entities was necessary to promote compliance with that law. Second, the statement that an action was "in furtherance" of some end does not suggest that the end was a "substantial purpose" for the action, or that the actor even knew of the end when initiating the action. LGI carefully worded its response to the government's Request for Admission to say the former while suggesting the latter. According to the court, the evidence suggested that when LGI's board decided to enter Project Soy, it did not discuss (or apparently, even know of) the changes in Belgian law that it now claims the transaction "further[ed].

Similarly, LGI's gestures to the attendant benefits of the sub-transactions in each of Steps 1 through 3 —such as the ability to issue profit certificates by converting Telenet Group from a BVBA to an NV, or the acquisition of preferential distribution rights through the issuance of profit certificates — are inadequate to suggest that those consequences were a "substantial purpose" for entering the transaction, and moreover, are inconsistent with the "economic realities" of the situation that the Court is instructed by precedent to consider. *See Gregory*, 293 U.S. at 468. For example, because TGH owned Telenet Group, it did not need preference against itself, eliminating any need for issuance of profit certificates or preferred stock. This reality suggests that achieving distribution preference was not a substantial purpose for entering the transaction.

Instead, the court believed that the only substantial purpose of the transaction was tax avoidance. LGI admitted that "from its perspective, the primary purpose of Steps 1, 2, and 3 of the Transactions was to 'generate earnings and profits' for use in Step 4" and adding only that Step 1 was also undertaken to comply with Belgian law. LGTs *ex post* arguments about the possible benefits that the profit certificates and entity conversion provided were inadequate to raise a genuine fact issue about whether those consequences were a "substantial purpose" for those operations, when the evidence demonstrated that LGI either did not know of the benefit when making the decision, did not discuss it as a reason to engage in the overall transaction, or did not achieve the cited benefit from the transaction in reality.

Finally, according to the court, even if an isolated step *did* provide objective benefits for LGI, it does not follow that the achievement of that outcome was a "substantial" non-tax purpose for the entire scheme. The economic substance inquiry is not a mathematical aggregation of isolated attendant benefits of sub-transactions; it is an inquiry into the interactions between the sub-transactions and what those interactions reveal about the transaction's overall purpose. *See Blum,* 737 F.3d 1312 (rejecting the taxpayers' argument that "because Dr. Hodder testified that each step of OPIS [the transaction] had economic substance, and that there was an enormous possible upside to OPIS," the overall transaction presented a reasonable chance of turning a profit and therefore had economic substance, because to accept that argument would require the court "to look not at the forest but at the trees"); *see also WFC Holdings Corp. v. United States*, 728 F.3d 736, 746 (8th Cir. 2013) (rejecting an effort to justify a basis-inflating scheme by "isolating] a kernel of prospective profitability to justify a large, multi-step, multi-property transaction").

The court emphasized that as in *Blum* and *WFC Holdings,* even if there was a possible kernel of purpose or a prospective "upside" to any of the steps—for example, accepting LGI's assertion that compliance with Belgian law was considered a motivation, or that the profit certificates would allow LGI some preference in Telenet's distribution rights and that this would matter even though LGI owned Telenet—the isolated benefits of one step cannot be extrapolated to a conclusion that those benefits were even related to the overall purpose of the transaction, let alone that they were a substantial purpose for the transaction.

Such an extrapolation would be particularly unfounded in the context of the "unitary plan" of Project Soy. *ECF* No. 76-8 at 5. There would be little reason for LGI to conceive of the first three steps as part of a larger "project" culminating in the sale of TGH to Liberty Global, if those first three steps were unrelated to the sale and were in fact in pursuit of entirely separate ends—ranging from distribution rights to Belgian corporate compliance. To accept the potential for preferential distribution rights, for example, as a rationale for the reorganization and conversion that took place in the same transaction would be similarly to "isolate a kernel" of benefit to the taxpayer and extrapolate without any logical or factual basis to an inference about the broader transaction. *WFC Holdings,* 728 F.3d at 746.

According to the court, LGI did not create a genuine issue as to whether the entire multi-step transaction took place for any substantial reason other than tax avoidance. The direct and circumstantial evidence established only the tax-avoidance purpose for the scheme. LGI's suggested alternative non-tax purposes for the individual steps are contradicted by the testimony of its own representatives, and in any event, simply do not make sense as justifications for the full transaction. Therefore, because there is no genuine issue of fact as to either the first or second prong, and both prongs resolve in favor of the application of the economic substance doctrine, it is appropriate as a matter of law to apply the ESD and to disregard Steps 1 through 3. When Steps 1 through 3 are disregarded, the noneconomic E&P generated in the § 351 transaction are not recognized and cannot be used to support the § 245A deduction. Step 4, the TGH Transaction, would then result in $2.4 billion of taxable gain.

ANALYSIS

There are layers of problems with the court's decision.[5] At the threshold, the court's conclusion that there is no separate inquiry into the "relevance" of the ESD in connection with the application of Section 7701(o) is simply inconsistent with both the statutory language and the legislative history of that provision. Congress clearly intended that the historical scope of the ESD should be taken into account as the first step in applying Section 7701(o), and the court's conclusion that the ESD applies to any transaction when the two prongs set forth in the statute are met effectively read the "relevance" clause out of the Code and created surplusage.

Another questionable aspect of the court's reasoning was its view that a transaction is not a basic business transaction because an accounting firm (here, Deloitte) was involved in the generation and implementation of the transaction. Although Project Soy did not arise without involvement by Deloitte, that involvement should

© 2024 Thomson Reuters

not taint what otherwise may have been an acceptable transaction – accountants and lawyers regularly provide clients with advice concerning potential reorganizations regardless of the anticipated tax effects of the transaction.

A further problem arises due to the court's conclusion that the various steps of the transaction are disregarded EXCEPT the step that resulted in the recognition of $2.4 billion of gain due to the sale of Telenet. This conclusion is contrary to the court's other conclusion that, in order to apply the ESD, all of the steps of the transaction must be considered together and steps cannot be viewed in isolation. Because the application of the ESD requires that transactions subject to the doctrine are given no tax effect at all, the court's ruling is inherently self-contradictory – the court can apply the ESD in order to disregard the transaction and disallow the tax benefit that LGI claimed, but the court cannot respect some steps that generate gain but disregard the other steps that convert that gain into a non-taxable dividend. In other words, if the court believes that the entire set of integrated steps had to be taken into account in applying the ESD, it could not then respect some steps (that created a tax liability) while disregarding other steps (that created a tax benefit) that were all part of an integrated series of steps.[6]

Another troubling aspect of this opinion is that the court did not even consider whether or not the step-transaction doctrine applied but, rather, jumped immediately to application of the ESD. In doing so, the court failed to even consider the IRS guidance which requires that agents consider the application of the other judicial doctrines before applying the ESD. See Lipton, "New Guidance Sheds Light on Economic Substance Doctrine and Related Penalties," 121 JTAX 26 (December 2014). The IRS approach is better because the other judicial doctrines are first applied in order to determine the "substance" of the transaction (in a "substance over form" context), and if the taxpayer's desired tax consequences are altered by that analysis, then the substance of the transaction is considered and not the ESD. Thus, the application of the ESD is deferred until that substance is identified. By jumping straight to the ESD, the court failed to take a necessary step in the analysis required by Section 7701(o).

Sadly, the court's decision appears to be another example of the application of "Section I don't like it" rather than a proper and methodical application of the judicial doctrines, including the application of Section 7701(o) of the Code.[7] The court did not like the fact that the planning idea for Project Soy arose with Deloitte (and not with the taxpayer) and that the steps of the transaction resulted in a major tax benefit as a result of the literal language of the Code. But the ESD should not apply in this manner – it was incumbent on the court to first determine whether the ESD was "relevant," taking into account the case law setting forth the boundaries for application of that doctrine. The court clearly should have first considered whether the step transaction doctrine applies, because the ESD is applied only after the entire substance of a transaction has been determined. Once the substance of the transaction was considered, then (and only then) should the court have considered whether or not the ESD was relevant. And if the doctrine was relevant, after taking into account the step-transaction doctrine and the substance over form doctrine, then it would have been appropriate for the court to consider whether the ESD required the court to disregard the entire transaction (and not disregard only the steps that provided tax benefits to the taxpayer).

End Notes

1 In Steps 1-3, LGI manufactured $4.8 billion of E&P for TGH. Steps 1 and 3 generated E&P for TGH by issuance of profit certificates from Telenet Group (the operating subsidiary) to TGH. Steps 2 and 3 generated E&P for TGH by creating "springing to life debt" — by converting Telenet Financing into a direct subsidiary of TGH rather than an indirect subsidiary through Telenet Group, and then making Telenet Group a separate entity for tax purposes. Generating E&P was important because the proceeds from the sale of a CFC (the transfer of LGI's interest in TGH to Liberty Global in Step 4 of Project Soy) could be treated as a dividend "to the extent of the [CFC's] E&P" under §§ 964(e)(1) and 1248(a). ECF No. 76-13 at 3 (quoting an internal LGI memo). In other words, if TGH had sufficient E&P, LGI could treat its gain as a dividend and offset the entire $2.4 billion by claiming a § 245A deduction.

2 BVBAs are akin to limited liability companies in the U.S. and usually are not taxed as separate entities (i.e., they are "disregarded"); NVs are akin to corporations in the U.S. and are considered separate entities for tax purposes.

3 Similarly, the court stated that LGI's citation to *Summa Holdings, Inc. v. Commissioner,* 848 F.3d 779, 788 (6th Cir. 2017), for the proposition that "a taxpayer has a right (and even a duty) to choose how an entity is taxed 'based solely on tax-reduction considerations,'" The notion that to limit taxpayers' abilities to evade taxes would infringe upon their rights is simply contrary to the meaning and purpose of the ESD.

4 The exemptions noted in the report are as follows: (i) choice of capitalization of a business, (ii) choices between foreign and domestic entities; (ii) organizations of a corporate entity; and (iv) choice to use related parties. H.R. Rep. 111-443 at 296.

5 See Henderson, "Liberty Global Economic Substance Analysis Merits a Reversal," Tax Notes, December 4, 2023.

6 Apparently the court did not want to apply the ESD to steps in isolation, including particularly step 3 that generated earnings and profits, so the court applied the ESD to the entire transaction. But that means the entire transaction should be disregarded for tax purposes, which is not what the court concluded.

7 Lipton, 2019 Erwin Griswold Lecture before the American College of Tax Counsel, "Proper Application of the Judicial Doctrines and Elimination of Section I Don't Like It," 72(3) Tax Law (2019).

© 2024 Thomson Reuters