IN THE UNITED STATES TAX COURT

SUNIL S. PATEL AND LAURIE MCANALLY PATEL, *Petitioners*, *v*. COMMISSIONER OF INTERNAL REVENUE, *Respondent*.	Docket Nos. 24344-17, 11352-18, and 25268-18

MOTION FOR LEAVE TO FILE AS *AMICUS CURIAE*

AND

***AMICUS CURIAE* BRIEF OF NATIONAL TAXPAYERS UNION FOUNDATION IN SUPPORT OF PETITIONERS**

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August 21, 2024

Counsel for Amicus Curiae

MOTION FOR LEAVE TO FILE *AMICUS CURIAE* BRIEF

Pursuant to Tax Court Rule 151.1(b) and this Court's Order on July 19, 2024, the National Taxpayers Union Foundation ("NTUF") moves for leave to file the attached *amicus curiae* brief in support of Petitioners. *See* Order, *Sunil S. Patel & Laurie McAnally Patel v. CIR*, T.C. No. 24344-17 (July 19, 2024), Dkt. No. 366. All parties consent to the filing of motion for leave to file an *amicus curiae* brief.

Founded in 1973, the National Taxpayers Union Foundation ("NTUF") is a non-partisan research and educational organization dedicated to showing Americans how taxes, government spending, and regulations affect everyday life. NTUF advances principles of limited government, simple taxation, and transparency on both the state and federal level. NTUF's Taxpayer Defense Center advocates for taxpayers in the courts, produces scholarly analyses, and engages in direct litigation and *amicus curiae* briefs upholding taxpayers' rights and challenging administrative overreach by tax authorities.

NTUF has expertise on the practical application of IRC § 7701(o) and the issue of the need for a threshold relevancy inquiry under the statute before a court applies the Economic Substance Doctrine. *Amicus* and its sister organization have written on the dangers of an over-broad application of the Economic Substance Doctrine. *See, e.g.*, Pete Sepp, *Comments on IRS REG-124593-23, "Certain Partnership Related-Party Basis Adjustment Transactions as Transactions of*

Interest," and Related Guidance, Nat'l Taxpayers Union (Aug. 21, 2024) *available at* https://www.ntu.org/library/doclib/2024/08/NTU-Comments-IRS-Docket.pdf; Pete Sepp, *"Abusive Tax Shelters" or Abuse of Taxpayers? IRS Should Learn Difference*, Nat'l Taxpayers Union (July 16, 2018) *available at* https://www.ntu.org/publications/detail/abusive-tax-shelters-or-abuse-of-taxpayers-irs-should-learn-difference. Accordingly, *Amicus* has an interest in this case.

Amicus therefore respectfully requests that this Court grant its motion for leave to file the attached *amicus* brief.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that I electronically filed the foregoing Motion for Leave to File *Amicus Curiae* Brief using the court's DAWSON system. A Notice of Docket Activity will be emailed to all registered attorneys currently participating in this case, constituting service on those attorneys:

/s/ Joseph D. Henchman
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AMICUS CURIAE BRIEF OF NATIONAL TAXPAYERS UNION FOUNDATION IN SUPPORT OF PETITIONERS

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CORPORATE DISCLOSURE STATEMENT

Pursuant to Tax Court Rules 151.1(c)(1) and 20(c), counsel for *Amicus Curiae* certifies that the National Taxpayers Union Foundation is a nonprofit, tax-exempt organization under Internal Revenue Code §501(c)(3) and is incorporated in the District of Columbia. *Amicus* further states that it has no parent companies, subsidiaries, or affiliates that have issued shares to the public.

s/ Joseph D. Henchman
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INTEREST OF AMICUS CURIAE

Founded in 1973, the National Taxpayers Union Foundation ("NTUF") is a non-partisan research and educational organization dedicated to showing Americans how taxes, government spending, and regulations affect everyday life. NTUF advances principles of limited government, simple taxation, and transparency on both the state and federal level. NTUF's Taxpayer Defense Center advocates for taxpayers in the courts, produces scholarly analyses, and engages in direct litigation and *amicus curiae* briefs upholding taxpayers' rights and challenging administrative overreach by tax authorities. Accordingly, *Amicus* has an institutional interest in this case. All parties consent to the filing of this brief.[1]

SUMMARY OF THE ARGUMENT

The Economic Substance Doctrine is a dangerous tool to give the government and thus must be used rarely and only when a threshold determination that it "relevant" to use. Congress recognized the danger when it wrote 26 U.S.C. § 7701(o)—explicitly calling for its use only when the doctrine is "relevant." *See* 26 U.S.C. § 7701(o) ("[i]n the case of any transaction to which the economic substance doctrine is relevant"). Determining how to reconcile pre-enactment case law with

[1] *Amicus Curiae* confirms that this brief was not authored in whole or in part by counsel for any party, and no person or entity other than *Amicus* and its counsel made a monetary contribution to the preparation or submission of this brief.

the § 7701(o) "relevant" standard is no easy task, but this case affords this Court the opportunity to do so.

This is vitally important, for the IRS should not be able to set aside a transaction as lacking economic substance if Congress created an incentive structure like micro captive insurance plans. Not only is seeking tax-advantageous results perfectly proper under long-established case law, Congress uses tax incentives to engineer economic outcomes. For example, Congress favors small businesses with the 26 U.S.C. § 199A deduction, encourages environmental and historical investments with tax benefits, and promotes home buying with significant tax advantages via the mortgage interest deduction. That a taxpayer engages in many of these activities precisely because they provide tax benefits does not mean they lack economic substance.

This case gives this Court the opportunity to articulate a relevance standard for applying § 7701(o). But in doing so, this Court should craft a rule that avoids the government second-guessing any transaction undertaken for a tax benefit that is clearly allowed by Congress.

ARGUMENT

I. THE ECONOMIC SUBSTANCE DOCTRINE MUST BE USED ONLY WHEN RELEVANT AND NARROWLY APPLIED.

A. Courts Need to Make a Threshold Determination that the Economic Substance Doctrine Applies.

Under the two elements of 26 U.S.C. § 7701(o)(1), a transaction has economic substance only when the transaction meaningfully changes the taxpayer's economic position, and when the transaction is supported by substantial nontax purpose. But, in the abstract, much financial planning would trigger the economic substance doctrine. A threshold test—relevance—is necessary that the exception does not subsume the rule. The statute itself demands it. *See id*. ("*In the case of any transaction to which the economic substance doctrine is relevant*, such transaction shall be treated as having economic substance only if…" the two elements are met) (emphasis added).

While Congress did not define relevance, it did require it: "The determination of whether the economic substance doctrine is relevant to a transaction shall be made in the same manner as if this subsection had never been enacted." 26 U.S.C. § 7701(o)(5)(C). Section 7701(o)'s legislative history confirms that the doctrine cannot override the plain meaning and application of Code provisions. For example, the House Budget Committee's report asserted that § 7701(o) did "not change current [case] law standards in determining when to utilize an economic substance

analysis," that is in determining when the doctrine "relevant." H.R. Rep. No. 111-443 (2010) at 295–96. Indeed, § 7701(o) was "not intended to alter the tax treatment" of certain transactions that "are respected" "under longstanding judicial and administrative practice," even though they are "largely or entirely based on comparative tax advantages." *Id.* at 296. Thus, where, as here, "the tax benefits are clearly consistent with all applicable provisions of the Code and the purposes of such provisions" this Court cannot use § 7701(o) to disallow the use of micro captive insurance "if the only reason for such disallowance is that the transaction fails the economic substance doctrine as defined in this provision." *Id*. 296 n.124.[2]

This Court should therefore declare that the § 7701(o) relevancy test is required. Without a relevancy inquiry, the economic substance doctrine will be applied to any of the hundreds of tax-advantaged provisions in the Internal Revenue

[2] If this Court finds § 7701(o)'s "relevant" provision ambiguous, it should err on the side of providing more due process to the taxpayer, and follow the "well-established method[] of interpreting revenue statutes" under which "doubt should be resolved in favor of the taxpayer." *Duke Energy Nat. Gas Corp. v. Comm'r*, 172 F.3d 1255, 1260 n.7 (10th Cir. 1999) (quoting *Hassett v. Welch*, 303 U.S. 303, 314 (1938)). This is the majority rule in the U.S. Court of Appeals. *See, e.g., Kisor v. McDonough*, 995 F.3d 1347, 1369 (Fed. Cir. 2021); *Exxon Mobil Corp. & Affiliated Cos. v. C.I.R.*, 689 F.3d 191, 199 (2d Cir. 2012); *United States v. Marshall*, 798 F.3d 296, 319 (5th Cir. 2015); *Saginaw Bay Pipeline Co. v. United States*, 338 F.3d 600, 604 (6th Cir. 2003); *Busse v. C.I.R.*, 479 F.2d 1147, 1150–51 (7th Cir. 1973); *Clajon Gas Co., L.P. v. C.I.R.*, 354 F.3d 786, 789 (8th Cir. 2004); *Royal Caribbean Cruises, Ltd. v. United States*, 108 F.3d 290, 294 (11th Cir. 1997).

Code in a manner that substitutes the government's judgments in place of the citizens' decisions.

Relevancy must be more than whenever the government raises the issue or a judge thinks a transaction does not pass a subjective "smell test." Litigation aiming to do so has not yet produced a workable definition. *See*, *e.g.*, Andy Grewal, *When Is the Economic Substance Doctrine 'Relevant' to a Transaction*? 13–14 (Iowa Legal Studies R. Paper No. 2023-29) (Sep. 2023) *available at*: https://dx.doi.org/10.2139/ssrn.4193230. (describing lack of test); *id*. at 20 ("A judicial attempt to provide an answer [to how to formulate a test under §7701(o)] seems doomed to failure.").

Amicus suggests a modest approach: presuming economic substance is satisfied in business transactions unless and until there is clear evidence that the taxpayer attempted to avoid paying taxes at all. Only then should a court begin to apply the factors of §7701(o). Mere use of a Congressionally-created program for small business insurance coverage is not enough to say the Patels' actions lack economic substance.

B. Section 7701(o) Does Not Apply to Merely Taking a Tax Advantage Specifically Created by Congress.

It is black letter law that taxpayers are legally permitted to structure their business transactions in a manner that produces the least amount of tax. As recently as 2008, the Supreme Court recognized that it has long been the rule that a taxpayer

holds the "'legal right… to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits.'" *Boulware v. United States*, 552 U.S. 421, 429 n.7 (2008) (quoting *Gregory v. Helvering*, 293 U.S. 465, 469 (1935)). But beyond mere tax minimization, the Internal Revenue Code offers many reasons for a person or entity to act or structure their dealings in ways that are tax advantageous.

Many statutory tax provisions invite taxpayers to engage in transactions principally or solely for their tax reasons. For example, a business may elect to file as an S corporation rather than as a C corporation, based entirely upon the tax benefits. S corporations, defined and regulated at 26 U.S.C. § 1361 *et seq.*, allows shareholders to elect to pass through taxation to the shareholders, thus eliminating double taxation and a possibly lower rate based on an individual's tax bracket. *See, e.g.*, *Gitlitz v. Comm'r*, 531 U.S. 206, 208 (2001) (describing benefits of S corporation election). These benefits are so significant that, since 1997, S corporations have continued to be the most common type of corporate tax status. Int. Rev. Serv., SOI Tax Stats — S Corporation Statistics *available at*: https://www.irs.gov/statistics/soi-tax-stats-s-corporation-statistics#basictables. And S corporations provide a major component of the American economy. S Corp. Ass'n, LARGE S CORPORATIONS AND THE TAX CUTS AND JOBS ACT: THE ECONOMIC FOOTPRINT OF THE PASS-THROUGH SECTOR AND THE IMPACT OF THE TCJA at i (Oct.,

2019) (S Corporations "employ a majority of private sector workers (58%), and pay a significant share of all business taxes (51%)") *available at* https://s-corp.org/wp-content/uploads/2019/10/EY-S-Corporation-Association-report-Economic-footprint-and-impact-of-TCJA-on-large-S-corporations-October-2019.pdf. All of this is made possible by the choice to take the favorable tax status of the S corporation.

Tax status is by no means the only way the Internal Revenue Code shapes and changes society. Congress sometimes creates tax incentives to stimulate activity that would otherwise go underserved. For example, historic rehabilitation credits attract investors to preserve historic buildings that might otherwise be demolished or allowed to deteriorate. *See* 26 U.S.C. § 47. Likewise renewable energy credits are designed to attract investment in new energy technologies. *See*, *e.g.*, *Sacks v. Comm'r*, 69 F.3d 982, 984 (9th Cir. 1995) (describing history of the 1970s oil crises and Congress' attempts to spur investment in non-fossil-fuel alternatives). Similarly, Congress provided that a tax deduction for conservation-related charitable contributions, 26 U.S.C § 170(h), which created a bargain for the government. Approximately $2 billion to $9 billion each year is deducted from conservation easements on real estate, compared to the almost $19 billion spent on managing public lands. *See*, *e.g.*, Int. Rev. Serv., SOI Tax Stats — Individual Noncash Charitable Contributions (collecting data by tax year) *available at*:

https://www.irs.gov/statistics/soi-tax-stats-individual-noncash-charitable-contributions; Cong. R. Serv., FEDERAL LAND OWNERSHIP: OVERVIEW AND DATA 22 (Mar. 3, 2017) *available at:* https://crsreports.congress.gov/product/pdf/R/R42346/15) (estimating $18.6 billion maintenance backlog for the National Park Service, Bureau of Land Management, Fish and Wildlife Service, and Forest Service).

For individuals, the mortgage interest deduction encourages home ownership and effects how and when families refinance their home loans. *See generally* Tess Scharlemann and Eileen van Straelen, American Economic Ass'n, MORE TAX, LESS REFI? THE MORTGAGE INTEREST DEDUCTION AND MONETARY POLICY PASS-THROUGH 30–31 (Dec. 20 2022) *available at*: https://www.aeaweb.org/conference/2023/program/paper/Skh8KZEs (concluding that the impact of the Tax Cuts and Jobs Act expansion of the standard deduction resulted in the less frequent use of the mortgage interest deduction that "cannot be explained by other factors that drive refinancing, like pre-tax refinance savings"). Even moving money from a brokerage account into a tax-favored Roth retirement account could fail both elements of § 7701(o)—after all, the move was done *precisely* for the tax benefit and there is no profit at the end of the deal because the same amount of savings remains.

Many other examples could be found by looking at the ever-complex Internal Revenue Code. But "[t]o apply the economic substance doctrine," in such instances,

"would be poor policy" that thwarts the designs of Congress. Jonathan H. Choi, *The Substantive Canons of Tax Law*, 72 STAN. L. REV. 195, 203–04 (2020). To do otherwise would invariably favor the government. Indeed, the "economic substance doctrine usually produces a result that is inconsistent with the text of the tax code" which "raises concerns about predictability and determinacy" in the revenue laws. Alexandra M. Walsh, *Formally Legal, Probably Wrong: Corporate Tax Shelters, Practical Reason and the New Textualism*, 53 STAN. L. REV. 1541, 1560 (2001). The economic substance doctrine should therefore be sparingly used and applied narrowly.

As the Sixth Circuit asked rhetorically, "[W]ho is to say that a low-tax means of achieving a legitimate business end is any less 'substantive' than the higher-taxed alternative?" *Summa Holdings, Inc. v. Comm'r of Int. Rev.*, 848 F.3d 779, 787 (6th Cir. 2017). That is why the *Summa Holdings* court held that if the Code "authorizes the 'formal' transactions the taxpayer entered into, then 'it is of no consequence that it was all an elaborate scheme to get rid of income taxes.'" *Id*. (quoting *Helvering v. Gregory*, 69 F.2d 809, 810 (2d Cir. 1934) and also citing David P. Hariton, *Sorting Out the Tangle of Economic Substance*, 52 TAX LAW. 235, 236–41 (1999)). Judges should be wary of placing themselves in the seat of the taxpayer making choices Congress allowed.

CONCLUSION

For the foregoing reason, *Amicus Curiae* urges this Court to apply a relevance test before invoking 26 U.S.C. § 7701(o) and, if relevant, using a narrower application of the economic substance doctrine.

Respectfully submitted,

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Dated: August 21, 2024

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CERTIFICATE OF COMPLIANCE

This brief complies with the type-volume limitation of this Court and the briefing Order because this brief is less than 50 pages.

This brief complies with the typeface and type style requirements because this brief has been prepared in a proportionally-spaced typeface using Microsoft Word in Times New Roman 14-point font.

s/ Joseph D. Henchman
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