



TaxNewsFlash

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U.S. Tax Court: Application of codified economic substance doctrine under section 7701(o) requires threshold “relevancy” determination

The U.S. Tax Court today held that the taxpayers were liable for accuracy-related penalties under sections 6662(a) and 6662(b)(6), which applies the economic substance doctrine as codified under section 7701(o), as well as the increased penalty under section 6662(i), in connection with the taxpayers’ claimed deductions under section 162 for amounts paid to purported captive insurance companies.

The case is: *Patel v. Commissioner*, 165 T.C. No. 10 (November 12, 2025). Read the Tax Court’s [opinion](#)

Summary

In its first decision weighing application of the codified economic substance doctrine under section 7701(o) (enacted in 2010), the Tax Court held that under the clear statutory language of section 7701(o), the codified economic substance doctrine requires a threshold “relevancy” determination.

The court then concluded—based on caselaw in which the economic substance doctrine had been applied in a variety of circumstances involving insurance transactions and, in particular, captive insurance transactions—that the codified economic substance doctrine was relevant in this case.

Finding that the captive insurance transactions did not change the taxpayers’ economic position in a meaningful way (apart from federal income tax effects), the court held that the economic substance doctrine applied. In addition, even though the court stated that the taxpayers’ failure of that objective test was sufficient to conclude that the taxpayers’ transactions lacked economic substance, for the sake of completeness the court also applied a subjective test and found that the taxpayers did not have a substantial purpose (apart from federal income tax effects) for entering into the micro-captive arrangements.

Finally, the court held that the taxpayers were also liable for increased penalties under section 6662(i) for nondisclosed noneconomic substance transactions under section 6662(b)(6) because the taxpayers did not attach a statement to their returns, nor did they adequately disclose the relevant facts or provide sufficient information on their returns, to enable the IRS to identify the potential controversy involved.

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