15-478

No. 15 - ____

IN THE

Supreme Court of The United States

AMERICAN INTERNATIONAL GROUP, INC.,
Petitioner,

v.

UNITED STATES OF AMERICA,
Respondent.

On Petition for a Writ of Certiorari
To the United States Court of Appeals
For the Second Circuit

PETITION FOR A WRIT OF CERTIORARI

David Boies
COUNSEL OF RECORD
Robin Henry
Edward Normand
BOIES, SCHILLER & FLEXNER LLP
333 Main Street
Armonk, New York 10504
(914) 749-8200
dboies@bsfllp.com

Thomas A. Cullinan
SUTHERLAND ASBILL & BRENNAN LLP
999 Peachtree Street, N.E.
Atlanta, Georgia 30309
(404) 853-8000

Jerome B. Libin
Daniel H. Schlueter
SUTHERLAND ASBILL & BRENNAN LLP
700 Sixth Street, NW #700
Washington, DC 20001
(202) 383-0100

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QUESTION PRESENTED

U.S. taxpayers are taxed in the United States on both income earned in the United States and income earned in foreign countries. Foreign countries also routinely tax U.S taxpayers on the income they earn in those countries. The Internal Revenue Code allows U.S. taxpayers to claim a dollar-for-dollar credit for qualifying foreign taxes paid. Congress intended to treat any such foreign income tax as the equivalent of U.S. income tax. The purpose of the foreign tax credit is to avoid double taxation of foreign transactions and remove tax impediments to business outside of the United States.

Several lower courts have imposed a further requirement for securing the foreign tax credit – that the activity upon which foreign tax is paid must have "economic substance," a requirement that typically focuses on whether the activity was expected to generate a "pre-tax profit." In the decision below, the Second Circuit held that for purposes of the economic substance requirement, U.S. taxpayers who earn income abroad must re-compute pre-tax profit to treat foreign tax as an expense. That holding is contrary to Congress' intent and is in express disagreement with the Fifth and Eighth Circuits. The decision plainly discriminates against, and calls into question a wide range of routinely conducted, cross-border transactions. Indeed, the Second Circuit acknowledged that its decision makes it more likely that foreign investment will fail the judicially imposed economic substance requirement.

The question presented is whether the Second Circuit erred in impeding, and discriminating against, foreign investment by treating foreign income taxes not as taxes, but as expenses, in determining entitlement to the foreign tax credit.

CORPORATE DISCLOSURE STATEMENT

Petitioner, American International Group, Inc. ("AIG"), is incorporated under the laws of Delaware. AIG has no parent corporation, and no publicly held corporation owns ten percent or more of AIG's stock.

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PETITION FOR A WRIT OF CERTIORARI

Petitioner, AIG, respectfully petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Second Circuit in this case.

OPINIONS BELOW

The opinion of the Court of Appeals for the Second Circuit (Pet. App. 3a-46a) is available at 2015 WL 5234396. The opinion of the district court (Pet. App. 47a-66a) is available at 2013 WL 1286193.

STATEMENT OF JURISDICTION

The decision of the Court of Appeals for the Second Circuit was issued, and judgment was entered, on September 9, 2015. This Court has jurisdiction under 28 U.S.C. § 1254(1).

STATUTORY AND REGULATORY PROVISIONS INVOLVED

Selected portions of Sections 78, 901, and 951 of the Internal Revenue Code, 26 U.S.C. §§ 78, 901, and 951, and of 26 C.F.R. § 1.901-2(a)(2), are attached at Pet. App. E-H.

STATEMENT OF THE CASE

This case presents an issue of critical importance to U.S. taxpayers engaged in cross-border business transactions. The current split among the Circuits pits the Second and Federal Circuits against the Fifth and Eighth Circuits. This Court's guidance is essential to resolve the pending controversy.

A. The Transactions at Issue

AIG claimed foreign tax credits in connection with six cross-border financing transactions entered into between 1993 and 1997 by AIG Financial Products Corp. ("AIG-FP"), a wholly owned subsidiary of AIG. AIG-FP was engaged in a global financial-services business, part of which was spread banking, in which it sought to make a profit by borrowing funds at rates generally below LIBOR and investing those funds at rates generally above LIBOR.

In each of the six transactions, AIG-FP formed an affiliate (a portfolio company) in a foreign country to invest funds borrowed from an unrelated foreign bank.[1] AIG-FP sold preferred stock in the portfolio company to the foreign bank and contracted to repurchase that stock for the same price after a term of years. The portfolio company then invested the proceeds from the sale of the preferred stock, along with funds that AIG-FP contributed in exchange for the portfolio company's common stock, in a portfolio of income-producing securities.

Under U.S. tax law, this sale and repurchase of preferred stock is treated as a fixed-term loan from the foreign bank to AIG-FP, secured by the preferred stock. As a result, for U.S. tax purposes, the preferred dividends the portfolio company paid to the counterparty constituted deductible interest payments made by AIG-FP. Under the applicable foreign law, the counterparty bank was treated as the owner of the preferred stock. As a result, the preferred dividends received by the foreign bank were expected to be exempt from tax (through either an exemption or tax credit) or subject to a reduced tax rate. This anticipated favorable tax treatment for the foreign

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[1] Subsidiaries of AIG-FP formed the foreign affiliates that held the stock. The existence of these other subsidiaries is irrelevant to the issue presented in this Petition.

bank enabled it to lend funds to AIG-FP at a lower rate – through a lower dividend rate on the preferred stock – than the bank would have charged if the payments received had been subject to full income tax in its home country.

In each transaction, the portfolio company paid tax on its income to the foreign country where it was resident. Under the Internal Revenue Code, AIG also reported the income earned by the portfolio company on its U.S. corporate income tax return; deducted the amounts paid to the foreign bank as interest expense; calculated its resulting U.S. tax liability; and, as permitted by U.S. tax law, claimed credits against its U.S. tax liability for the foreign taxes paid by the portfolio company. These are the foreign tax credits at issue here.

B. Procedural History

There is no dispute that AIG complied with the complex rules and limitations imposed by the foreign tax credit statutory and regulatory regime in claiming the foreign tax credits at issue. *See* 26 U.S.C. §§ 901 *et seq.* The IRS nevertheless disallowed the claimed credits, finding that the cross-border transactions lacked "economic substance."

AIG paid the taxes that the IRS claimed were due and then initiated a refund suit in the district court. Moving for partial summary judgment,[2] AIG argued that the borrowing transactions had economic substance because they allowed AIG-FP to earn at least $168.8 million of pre-

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[2] The motion was styled as such because there are unrelated issues in the case that have been severed and stayed to allow AIG and the Government to address them through the IRS administrative appeals process, and because the motion did not address a seventh cross-border transaction that was different in form from the six borrowing transactions at issue here.

tax profit using approximately $1.6 billion of borrowed funds. AIG calculated that profit by adding the amounts AIG-FP reasonably expected to earn from the borrowed funds and subtracting its borrowing costs, using figures provided by a government-retained expert.

The district court denied AIG's motion. In applying the economic substance doctrine, the court agreed that AIG would be entitled to judgment if its pre-tax profit computation of $168.8 million were correct. (A. 60a-61a.) It found, however, that AIG's computation improperly included the foreign tax benefits for the foreign banks. The district court held that the foreign tax benefits had allowed the interest rate to be set at a lower level and thus must be removed from pre-tax profit, netting AIG no profit from the transactions. (A. 64a-66a.)

The district court certified its order for interlocutory appeal under 28 U.S.C. § 1292(b), and AIG filed a petition for leave to appeal in the Second Circuit. The Second Circuit granted the petition and heard AIG's appeal together with an appeal filed in a different case by Bank of New York Mellon (the cases were not consolidated but were resolved in the same decision).

The Second Circuit affirmed the district court's order, but based on different reasoning than the district court had employed. Rather than requiring AIG to remove the effect of the foreign banks' tax benefits on the borrowing rates, the Second Circuit held that the foreign taxes paid by the portfolio companies "are economic costs and should thus be deducted when calculating pre-tax profit." (A. 45a.) Clearly announcing a general rule for all cross-border transactions, the Second Circuit stated: "We conclude, as a matter of first impression in this Circuit, that foreign taxes are economic costs and should thus be deducted when calculating pre-tax profit. We also conclude that it is appropriate, in calculating pre-tax profit, for a court both to include the foreign taxes paid and to exclude the foreign tax credits claimed." (*Id.*)

In so holding, the Second Circuit expressly disagreed with the holdings of the Fifth Circuit in *Compaq Computer Corp. v. Commissioner*, 277 F.3d 778 (5th Cir. 2001), and the Eighth Circuit *IES Industries, Inc. v. Commissioner,* 253 F.3d 350 (8th Cir. 2001). (A. 26a-33a.) In those cases, the Circuit Courts held that, in determining whether a transaction has economic substance, foreign taxes must be treated as taxes rather than as expenses for purposes of computing pre-tax profit and, therefore, that foreign taxes should not be counted in determining whether a transaction is profitable apart from its tax consequences.

REASONS FOR GRANTING THE WRIT

This Court should grant this Petition for three compelling reasons. First, as the Second Circuit acknowledged, its decision is in square conflict with the decisions of two other Circuits on the question presented. Second, the issue is fundamental to every U.S. taxpayer that relies on the foreign tax credit to alleviate double taxation. Third, this case presents the Court with the most suitable opportunity for resolving the Circuit split at issue.

I. THE SECOND CIRCUIT'S DECISION DIRECTLY CONFLICTS WITH THE FIFTH AND EIGHTH CIRCUITS ON THE IMPORTANT QUESTION OF HOW TO TREAT FOREIGN TAXES PAID WHEN MEASURING THE PRE-TAX PROFIT OF A CROSS-BORDER TRANSACTION FOR PURPOSES OF THE ECONOMIC SUBSTANCE DOCTRINE

The Circuits now are sharply divided on the question at issue, with the Second and Federal Circuits holding that foreign income taxes should be treated as expenses and the Fifth and Eighth Circuits holding that

they should be treated as taxes. Absent this Court's review, these conflicting decisions will result in the disparate tax treatment of identically situated taxpayers. The issue is recurring and of national importance because the discriminatory treatment of foreign income taxes as expenses – unlike U.S. income taxes, which are treated as taxes – impedes cross-border activity. Treating foreign income tax as an expense makes it more likely that a transaction in which foreign income tax is paid will fail the economic substance test – and therefore not be respected for U.S. tax purposes – relative to an otherwise identical transaction in which only U.S. income tax is paid. As the Second Circuit observed, "a transaction will be less likely to appear profitable under the objective prong of the economic substance test" if foreign income taxes are "treated as costs when calculating pre-tax profit." (A. 25a.) This treatment contravenes the well-established purposes of the U.S. foreign tax credit regime, which are to avoid double taxation for the U.S. taxpayer and to encourage foreign business activity.

A. The Economic Substance Test

The Supreme Court conceived the economic substance doctrine as a tool of statutory construction for furthering congressional intent. In *Gregory v. Helvering*, 293 U.S. 465 (1935), the Court explained that a court's task is to assess whether the tax results of a transaction are consistent with the purpose of the statute at issue – to assess "whether what was done . . . was the thing which the statute intended." *Id.* at 469. In subsequent cases assessing economic substance, the Court has considered whether the facts of a transaction fall within the meaning of the Code provision or regulatory guidance at issue. *See, e.g.*, *Cottage Savs. Ass'n v. Comm'r*, 499 U.S. 554, 562 (1991); *Frank Lyon Co. v. United States*, 435 U.S. 561, 583-84

(1978); *Knetsch v. United States*, 364 U.S. 361, 362-66 (1960).[3]

The lower courts have applied the economic substance doctrine by considering both objective and subjective factors. The factors are (1) whether the transaction has objective economic utility apart from its tax consequences and (2) whether the taxpayer has a subjective non-tax business purpose for entering into the transaction. The lower courts generally give greater weight to the objective part of the test, reasoning that "where a transaction objectively affects the taxpayer's net economic position, legal relations, or non-tax business interests, it will not be disregarded merely because it was motivated by tax considerations." *ACM P'ship v. Comm'r*, 157 F.3d 231,

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[3] The Second Circuit thus erred in applying the economic substance doctrine in the first place. Congress enacted the foreign tax credit to alleviate the effect of double taxation. *See Kraft Gen. Foods v. Iowa Dep't of Rev. & Fin.*, 505 U.S. 71, 73 (1992); *United States v. Goodyear Tire & Rubber Co.*, 493 U.S. 132, 139 (1989). Foreign tax credits can be claimed only when a genuine liability to a foreign tax authority actually has arisen and actually has been accrued or discharged by a payment of tax. *See* 26 U.S.C. § 901(a), (b)(1); 26 C.F.R. § 1.901-2(a)(2). The statute precisely defines the requirements for claiming the credit in a manner that fully implements the statutory purpose. In this case, there is no dispute that the credits at issue are attributable to foreign income taxes that actually were imposed by a foreign tax authority and actually paid by the AIG group, and that denial of the credits thus would result in the imposition of both U.S. and foreign tax on these foreign transactions. The Second Circuit's application of the doctrine to deny AIG these credits thus fails the basic test articulated by *Gregory*, 293 U.S. at 469. When, as here, application of the Code provisions accomplishes exactly "the thing which the statute intended," use of a judicial doctrine to depart from the statutory text is inappropriate. *See id.*

248 n.31 (3d Cir. 1998); *see also United States v. Consumer Life*, 430 U.S. 725, 739 (1997) ("Even a major motive to reduce taxes will not vitiate an otherwise substantial transaction."). Courts consider whether a transaction has economic substance by assessing whether it may have resulted in a "pre-tax profit." The lower courts generally compute pre-tax profit by adding the amounts the taxpayer reasonably expected to earn from a transaction and subtracting transaction costs. *See, e.g., Goldstein v. Comm'r*, 364 F.2d 734, 740-43 (2d Cir. 1966).

B. The Circuits Are Split on How Foreign Taxes Should Be Treated in Determining Whether a Transaction Has Economic Substance

The Fifth Circuit in *Compaq Computer Corp. v. Commissioner*, 277 F.3d 778 (5th Cir. 2001), held that a fifteen percent Netherlands withholding tax imposed on dividend payments from a Dutch corporation to Compaq should be treated as a tax rather than as an expense for purposes of the pre-tax-profit analysis. Compaq bought American Depository Receipts (ADRs) in Royal Dutch Petroleum Company and shortly thereafter sold the ADRs at a loss of approximately $20.7 million. *Id.* at 780. Royal Dutch declared a dividend while Compaq was the shareholder of record, entitling Compaq to a dividend of approximately $22.5 million. Royal Dutch paid that dividend to Compaq, less about $3.4 million in foreign withholding tax that Royal Dutch paid to the Netherlands government, so that Compaq received a net dividend of $19.1 million. *Id.* The Tax Court held the Dutch tax was "a cost of the transaction" resulting in a net loss of "roughly $1.5 million." *Id.* at 782.

The Fifth Circuit reversed, noting that the test the Tax Court applied discriminated between foreign and U.S. taxes. *Id.* at 785. The Fifth Circuit held the transaction had

economic substance because it was profitable apart from taxes once the Dutch tax properly was treated as a tax instead of as an expense:

> If the effects of the transaction are computed consistently, Compaq made both a pre-tax profit and an after-tax profit from the ADR transaction. Subtracting Compaq's capital losses from the gross dividend rather than the net dividend results in a net pre-tax profit of about $1.894 million. Compaq's U.S. tax on that net pre-tax profit was roughly $644,000. Subtracting $644,000 from the $1.894 million results in an after-tax profit of about $1.25 million. The transaction had economic substance.

Id. at 786. The Eighth Circuit had reached a similar result on similar facts in *IES Industries, Inc. v. United States,* 253 F.3d 350 (8th Cir. 2001).

The Federal Circuit disagreed (albeit without acknowledging the split) with the Fifth and Eighth Circuits in *Salem Fin., Inc. v. United States*, 786 F.3d 932 (Fed. Cir. 2015). That case involved a trust transaction in which BB&T paid $22 of U.K. tax for every $11 of income realized. The Federal Circuit held that the foreign tax should be treated as an expense, making the transaction "profitless" and therefore lacking economic substance. *Id.* at 949. In its decision below, the Second Circuit adopted the standard of the Federal Circuit and held "that foreign taxes are economic costs and should thus be deducted when calculating pre-tax profit." (A. 45a.) The court accordingly held that the foreign income taxes paid by AIG's portfolio companies on their investment income should be treated as expenses "and deducted from profit *before* calculating pre-tax profit." (A. 32a.) In summary, the court "agree[d] with the Federal Circuit in *Salem* and

disagree[d] with the decision of the Fifth and Eighth Circuits (*Compaq* and *IES*, respectively)." (A. 45a.)

C. Foreign Taxes Are Appropriately Treated as Taxes for Purposes of Determining Whether a Cross-Border Transaction Has Economic Substance

This Court should reverse the Second Circuit's decision because it upsets the equivalence of U.S. and foreign taxes in the U.S. foreign tax credit regime and will significantly impede cross-border investment, which would be contrary to the very purpose of the foreign tax credit. Congress enacted the foreign tax credit in 1918 "to mitigate the evil of double taxation" and to encourage foreign business transactions. *Burnet v. Chicago Portrait Co.*, 285 U.S. 1, 7 (1932); *see also Kraft Gen. Foods v. Iowa Dep't of Rev. & Fin.*, 505 U.S. 71, 73 (1992); *Goodyear Tire & Rubber Co.*, 493 U.S. at 139 (1989). Under the U.S. foreign tax credit regime (26 U.S.C. §§ 901 *et seq.*), a U.S. taxpayer engaging in a cross-border transaction subject to foreign income tax may claim (subject to various limitations) a dollar-for-dollar credit for the foreign tax paid. The credit is applied as an offset against the U.S. income tax otherwise due on the same transaction, with any excess offset against the taxpayer's U.S. tax on other foreign source income of a similar character.[4] This system essentially cedes taxing authority over foreign source

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[4] Given that U.S. taxpayers can claim only a dollar-for-dollar credit for foreign taxes paid or accrued, the foreign tax credit is not the typical tax "benefit" to which the courts traditionally have applied the economic substance test. It is undisputed that the transactions at issue caused AIG's worldwide tax liability to increase, and that AIG will suffer double taxation absent the foreign tax credit.

income to foreign jurisdictions and "in effect treats the taxes imposed by the foreign country as if they were imposed by the United States." H.R. Rep. No. 1337, 83rd Cong., 2d Sess. 76 (1954). In testing AIG's entitlement to a foreign tax credit in a manner that discriminates against foreign investment, the Second Circuit violated the foundational principle on which the foreign tax credit is based.

The Second Circuit's treatment of foreign income tax as an expense for purposes of the pre-tax profit test also is erroneous because it creates a mismatch with how foreign income tax is treated in computing U.S. gross income when foreign tax credits are claimed. AIG was required to report, and did report, all of the investment income earned by the portfolio companies in its U.S. gross income – *including* the portion that was used to pay foreign tax. 26 U.S.C. §§ 78, 951. There is no principled basis for treating foreign tax differently in computing pre-tax profit than how it is treated in computing U.S. gross income. To the contrary, the Fifth and Eighth Circuits both relied on the fact that the taxpayers in *Compaq* and *IES* were required to include the gross dividends (before payment of foreign tax) in their U.S. income to hold that the transactions had economic substance as a matter of law. *Compaq*, 277 F.3d at 783-84; *IES*, 253 F.3d at 354. As the Eighth Circuit put it: "Because the entire amount of the ADR dividend was income to IES, the ADR transactions resulted in a profit, an economic benefit to IES." *IES*, 253 F.3d at 354. AIG included in its U.S. gross income the foreign earnings it used to pay foreign tax, and it properly included those amounts in computing pre-tax profit for purposes of the economic substance test.

The test the Second Circuit adopted, in comparison, artificially excludes from the computation of pre-tax profit any foreign earnings that a U.S. taxpayer uses to pay foreign tax. That application of the test loses sight of the purpose of the test. The pre-tax profit test is only a tool to

aid a court in determining "whether what was done . . . was the thing which the statute intended." *Gregory*, 293 U.S. at 469. The Second Circuit, however, like some other lower courts, has imposed "economic substance" as a requirement unmoored to the purpose of the statute. That short-sightedness led the court to treat foreign tax as an expense notwithstanding that such treatment conflicts with the fundamental architecture of the foreign tax credit regime and with far more basic concepts of gross income.

The conflict between the Second and Federal Circuits and the Fifth and Eighth Circuits on the question here presented, as well as the erroneous Second Circuit analysis, compels this Court's review at this time.

D. Recent Legislation Makes Resolution of the Issue of the Appropriate Treatment of Foreign Taxes in Cross-Border Transactions Even More Important to U.S. Taxpayers

Congress codified the economic substance test in 2010. *See* 26 U.S.C. § 7701(o). That provision is effective for transactions entered into after March 30, 2010, and therefore does not apply in this case. Nevertheless, Congress' codification of the test makes it even more important that this Court resolve the issue presented in this Petition, as Congress acknowledged the import of the pre-tax profit test in enacting a "special rule" to govern its computation. *Id.* § 7701(o)(2)(A). The new statute does not answer whether a foreign income tax is properly treated as an expense for purposes of determining entitlement to a foreign tax credit. (The statute directs the Secretary of the Treasury to "issue regulations requiring foreign taxes to be treated as expenses in appropriate cases," *id.* § 7701(o)(2)(B), but the Secretary has not issued those regulations and there is nothing to indicate whether any such regulations would treat foreign income taxes – as

opposed to other types of foreign tax – as expenses or whether that treatment would apply when a foreign tax credit is at issue. The statute thus underscores the sweeping implications and misplaced policy of the Second Circuit's decision, which identifies foreign taxes as "economic costs" for all foreign transactions (A. 46a) – a result that Congress clearly did not intend.)

II. THE ISSUE PRESENTED IS FUNDAMENTALLY IMPORTANT TO EVERY U.S. TAXPAYER THAT RELIES ON THE FOREIGN TAX CREDIT TO ALLEVIATE DOUBLE TAXATION

The approach the Second Circuit adopted not only is legally erroneous, but also calls into question a wide range of routinely conducted cross-border business transactions and conflicts with Congress' intent on that further basis. The Second Circuit's decision that foreign income taxes are to be treated as expenses for purposes of determining pre-tax profit discriminates against foreign investment in contravention of U.S. tax policy.

In recent years the lower courts have treated the economic substance doctrine as a "trump card; even if a transaction complies precisely with all requirements for obtaining a deduction, if it lacks economic substance it simply is not recognized for federal taxation purposes, for better or for worse." *In re CM Holdings, Inc.*, 301 F.3d 96, 102 (3d Cir. 2002). As a result, taxpayers must consider the "economic substance doctrine" when planning transactions, just as they consider the Code and Treasury regulations.[5]

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[5] Congress' codification of the doctrine, as noted, makes this a certainty for transactions taking place after March 30, 2010.

Given the Second Circuit's decision in the context of such precedent, consider a simple example. A U.S. taxpayer borrows $1000 domestically at a rate of 3.0 percent and lends the funds to a U.S. borrower at a rate of 4.0 percent (that is, the taxpayer, like AIG-FP in this case, is engaging in spread banking). Its borrowing cost is thus $30 per year and it anticipates earning interest income of $40 per year, for a net profit of $10 before taxes. This transaction clearly would satisfy the "pre-tax profit" test and therefore be considered to have economic substance.

Assume instead, however, that the taxpayer lends the money to a foreign borrower and the borrower's country (like the U.S.) imposes a 30 percent statutory withholding tax on outbound interest payments. In that case, the taxpayer would have $12 withheld from the interest payment due and would receive only $28 of interest from the borrower. Under U.S. tax rules, however, the taxpayer would be required to report $40 of interest income because it earned $40. The taxpayer's pre-tax profit therefore again should be recognized as $10 ($40 of interest income less $30 of borrowing costs), and it should be allowed to claim a foreign tax credit for the $12 of foreign withholding tax imposed on it.

Under the Second Circuit's holding, however, the taxpayer would be required to treat the $12 of foreign withholding tax as an additional "expense" incurred in the transaction, thereby increasing its total expenses from $30 to $42 and causing the transaction to show a "pre-tax loss" of $2 for economic substance purposes ($42 in expenses less $40 in income), even though the taxpayer would still report $10 of net income for U.S. tax purposes. Showing a "pre-tax loss" for economic substance purposes could cause the taxpayer to lose its ability to claim a credit for the $12 of foreign taxes that it incurred. That risk, which does not exist in the domestic transaction, obviously would influence the taxpayer's decision whether to engage in the

cross-border version of the same transaction, contrary to the fundamental purpose of the foreign tax credit regime.

Under this example, the difference between the tests employed by the Fifth and Eighth Circuit ($30 of expenses), versus the one the Second Circuit adopted ($30 of expenses + $12 of foreign tax = $42 of "expenses"), is easily illustrated:

	U.S. Tax Consequences of Domestic Loan	Pre- and After-Tax Profit of Foreign Loan in Fifth and Eighth Circuits	Pre- and After-Tax Profit of Foreign Loan in Second Circuit
Income	40.00	40.00	40.00
Expense	(30.00)	(30.00)	(42.00)
Pre-tax income	**10.00**	**10.00**	**(2.00)**
Foreign tax	–	(12.00)	
U.S. tax (35%)	(3.50)	(3.50)	(3.50)
Foreign tax credit	–	12.00*	
After-tax income	**6.50**	**6.50**	**(5.50)**

* This example assumes that the taxpayer that lends the funds to a foreign borrower will be able to use the entire foreign tax credit to offset the U.S. tax that would be due on other foreign source income.

In short, including the foreign tax as an expense in computing pre-tax income would make most foreign investments look like they lack economic substance and thus disqualify them from a foreign tax credit, a far cry from the purpose of treating "the taxes imposed by the

foreign country as if they were imposed by the United States." H.R. Rep. No. 1337, *supra*.

In the aftermath of the Second Circuit and Federal Circuit decisions, taxpayers engaging in any number of cross-border transactions (like the one in the example) are faced with great uncertainty as to whether their particular transactions would satisfy the pre-tax profit test if challenged by the IRS. Indeed, the facts in the example need only be slightly revised to reflect AIG's transactions that the IRS did challenge.

The discriminatory nature of the Second Circuit test is especially relevant in this case. Although the Second Circuit conspicuously did not address the issue (which AIG briefed in some detail), AIG also borrowed funds from foreign banks through repurchase transactions that were identical in all material respects to the transactions here at issue except that the portfolio companies were domiciled in the United States rather than in foreign countries and therefore paid U.S. tax rather than foreign tax on their investment income.

The IRS never challenged those domestic transactions on economic substance grounds, or any other grounds. Instead, the IRS challenged only those of AIG's transactions that were subject to foreign income taxes. Challenging transactions of this type only when they involve foreign income taxes for which foreign tax credits may be claimed undercuts Congress' entire purpose in establishing the foreign tax credit regime, which was to neutralize the effect of foreign tax on a taxpayer's choice of business locale. And absent the foreign tax credit, AIG would have a strong incentive *always* to domicile the portfolio company in the United States, so that its income would be taxed only once.

The issue here presented might arise in connection with any cross-border business transaction. Taxpayers should not have to be concerned about whether they are vulnerable to an economic substance challenge and the

resulting possibility of double taxation whenever they choose to engage in a cross-border transaction, and incur foreign income tax, rather than engage in a domestic transaction of the same type. Given the conflict among the Circuits and the fact that the question is an important and recurring one for U.S. taxpayers engaging in international commerce, this Court's resolution of the issue at this time is essential to eliminate the continuing uncertainty and confusion that otherwise will exist regarding this fundamental doctrine of tax law.

The significant extent (and intensity) of the tax commentary regarding the critical aspects of the case underscores the importance of the questions at issue and the need for clarity. Tax commentators have addressed in detail (1) the soundness of the decisions in *Compaq* and *IES*, *see, e.g.*, Kevin Dolan, *The Foreign Tax Credit Diaries – Litigation Run Amok*, 71 Tax Notes 895, 905-07 (Aug. 26, 2013); Robert H. Dilworth, *The Sky Is Not Falling After Compaq: The Business Purpose Doctrine Is Alive and Well in the Fifth Circuit*, 793 PLI/Tax 323, 338 (2007); James M. Peaslee, *Creditable Foreign Taxes and the Economic Substance Profit Test*, 114 Tax Notes 443 (Jan. 29, 2007); William A. Klein & Kirk J. Stark, *Compaq v. Commissioner – Where Is the Tax Arbitrage?*, 94 Tax Notes 1335, 1340 (Mar. 7, 2002); Marc D. Teitelbaum, *Compaq Computer and IES Industries – The Empire Strikes Back*, 86 Tax Notes 829, 836 (Feb. 7, 2000); and (2) the unsoundness of the district court's decision in this case, *see, e.g.*, Dolan, *Litigation Run Amok*, *supra*; Richard Lipton, *BNY and AIG – Using Economic Substance to Attack Transactions the Courts Do Not Like*, 119 J. Tax'n 40 (July 2013); Jason Yen & Patrick Sigmon, *District Court's "AIG" Ruling Expands Application of Economic Substance Doctrine in Unexpected Ways for Transactions Generating Excess Foreign Tax Credits*, Daily Tax Report (May 5, 2013). Accordingly, even apart from endorsing the principles that support AIG in this case, such commentary

frames the Second Circuit's decision as among the "recent rash of economic substance cases" that turn on interpretation of *Compaq* and *IES*, and that in doing so create "new and significant complication for taxpayers." Yes & Sigmon, *supra*.

III. THIS CASE PRESENTS THE MOST SUITABLE OPPORTUNITY FOR THE COURT TO RESOLVE THE CIRCUIT SPLIT AT ISSUE

The question of whether to treat foreign taxes as an expense also arises in the petition for certiorari filed by Salem Financial, Inc. *See Salem Fin., Inc. v. United States*, 786 F.3d 932 (Fed. Cir. 2015), petition for cert. pending, No. 15 - ___ (filed September 29, 2015). In addition, in the case resolved in tandem with this case, The Bank of New York Mellon Corporation may choose to file a petition for certiorari. AIG respectfully submits that this case presents the most suitable opportunity for the Court to resolve the Circuit split at issue, because (1) this is the only case in which the material facts are undisputed (one of the reasons the case was certified for appeal to the Second Circuit), whereas the petition filed by BB&T makes factual assertions that appear to conflict with findings made in the lower court; (2) the borrowing transactions at issue in this case are far more straightforward than the complicated "STARS" transactions at issue in each of the *Salem Financial* and *Bank of New York Mellon* cases, and thus more squarely present the legal question at issue; and (3) whereas the Federal Circuit in *Salem Financial* declined to acknowledge the Circuit split its decision created, the Second Circuit did acknowledge and discuss that its decision reflected a split – and in doing so articulated a general rule identifying foreign taxes as "economic costs" for all foreign transactions (A. 46a) – and thus more directly framed the issue for this Court to resolve.

CONCLUSION

The Second Circuit's decision to treat the payment of foreign taxes as an expense in applying the economic substance doctrine conflicts with the decisions of the Fifth and Eighth Circuits. The decision also leaves intact the effective imposition of double taxation on a U.S. taxpayer and discriminates against foreign investment – precisely the outcomes that Congress created the foreign tax credit to avoid. The Court should provide guidance on this issue to resolve the Circuit split and to clarify an issue that is a critical factor for any U.S. taxpayer contemplating any of a wide array of cross-border transactions. For the foregoing reasons, the Petition for a Writ of Certiorari should be granted.

Respectfully submitted,

David Boies
Robin Henry
Edward Normand
BOIES, SCHILLER & FLEXNER LLP
333 Main Street
Armonk, New York 10504
(914) 749-8200
dboies@bsfllp.com

Thomas A. Cullinan
SUTHERLAND ASBILL & BRENNAN LLP
999 Peachtree Street, N.E.
Atlanta, Georgia 30309
(404) 853-8000

Jerome B. Libin
Daniel H. Schlueter
SUTHERLAND ASBILL & BRENNAN LLP
700 Sixth St., NW #700
Washington, DC 20001
(202) 383-0100