No. 16-

IN THE

Supreme Court of the United States

SANTANDER HOLDINGS USA, INC., AND SUBSIDIARIES,
F/K/A SOVEREIGN BANCORP, INC.,

Petitioner,

v.

UNITED STATES,

Respondent.

ON PETITION FOR WRIT OF CERTIORARI TO
THE U.S. COURT OF APPEALS FOR THE FIRST CIRCUIT

PETITION FOR WRIT OF CERTIORARI

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QUESTION PRESENTED

This case involves the "economic substance" (or "sham transaction") doctrine, which is a judge-made rule that serves as a tool of statutory interpretation under the Tax Code, assisting courts in conforming their decisions to congressional intent. *See Gregory v. Helvering*, 293 U.S. 465, 469 (1935). The doctrine asks whether a transaction has a reasonable prospect of generating a significant profit on a pre-tax basis. If so, the transaction is deemed to have economic "substance" and is not a "sham."

In this case, the First Circuit held that, under the economic substance test, a court should treat a U.S. taxpayer's foreign tax payments (but not its domestic U.S. tax payments) as "expenses" in assessing whether a transaction possesses a reasonable probability of pre-tax profit. Such an approach means that a transaction could pass the test if conducted within the U.S. (because domestic tax payments are not treated as "expenses") but could fail the test if conducted on a cross-border basis (because foreign tax payments, treated as expenses, would count against the profitability of the transaction). The First Circuit followed a rule established by the Federal and Second Circuits, in conflict with decisions in the Fifth and Eighth Circuits.

The Question Presented is:

Whether foreign tax payments should be treated as "expenses" and thereby factored into a court's pre-tax profitability calculation under the economic substance test.

PARTIES TO THE PROCEEDING

Petitioner is Santander Holdings USA, Incorporated. Respondent is the United States of America.

RULE 29.6 STATEMENT

Petitioner Santander Holdings USA, Inc. & Subsidiaries is wholly-owned by Banco Santander, S.A.

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PETITION FOR A WRIT OF CERTIORARI

Petitioner Santander Holdings USA, Inc. respectfully petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the First Circuit in this case.

OPINIONS BELOW

The opinion of the First Circuit (Pet. App. 1a) is published at 844 F.3d 115 (2016). The opinions of the United States District Court for the District of Massachusetts (Pet. App. 24a) are published at 977 F. Supp. 2d 46 (D. Mass. 2013), and 144 F. Supp. 3d 239 (D. Mass. 2015).

JURISDICTION

The District Court had federal question jurisdiction over Petitioner's federal claim for a tax refund under 28 U.S.C. § 1346(a)(1). The Court of Appeals issued its decision on December 16, 2016. Pet. App. 1a. This Court has jurisdiction under 28 U.S.C. § 1254(1).

STATUTE INVOLVED

Section 901 of the Internal Revenue Code, 26 U.S.C. § 901, and relevant portions of Treasury Regulation 1.901, 26 C.F.R. §1.901, are reproduced in the Appendix. Pet. App. 61a.

STATEMENT

Sovereign Bancorp, ("Sovereign") a U.S.-based corporate taxpayer,[1] earned income on assets held in a trust. Sovereign paid tax on that income to the government of the United Kingdom in accordance with U.K. law. Sovereign then claimed a foreign tax credit ("FTC") under U.S. law to avoid double taxation of the trust's income. There is no dispute that Sovereign complied with all aspects of the "byzantine structure of staggering complexity" that constitutes the FTC legal regime. Boris Bittker & James Eustice, *Federal Income Taxation of Corporations and Shareholders,* ¶ 15.21[1][a] (7th ed. Supp. 2014). As a matter of statute, therefore, Sovereign was entitled to FTCs. "If this case dealt with any other title of the United States Code, we would stop there, end the suspense, and rule for [Sovereign]. But when it comes to the Internal Revenue Code, the Commissioner claims a right to reclassify Code-compliant transactions under the [economic substance doctrine] in order to respect overarching principles of federal taxation." *Summa Holdings, Inc. v. Comm'r of Internal Revenue*, 16-1712, 2017 WL 631663, at *3 (6th Cir. Feb. 16, 2017) (per Sutton, J.) (internal citations omitted).

The IRS has followed such a strategy here. Despite Sovereign's compliance with all applicable statutory and regulatory provisions, the IRS

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[1] This case involves the tax liabilities of Sovereign for the 2003-2005 tax years. Petitioner Santander Holdings USA purchased Sovereign in 2009 and was substituted for Sovereign in this proceeding.

disallowed Sovereign's tax credit, asserting that the cross-border transaction that gave rise to the U.K. tax liability lacked "economic substance." The district court rejected the assessment and ordered a refund, but the First Circuit reversed the district court, allowing the Government to disallow Sovereign's FTCs, thereby requiring Sovereign to pay both U.K. and U.S. taxes on the same income – in clear violation of Congress' decision to establish FTCs to *prevent* double taxation.

The First Circuit's analysis is as troubling as the result. The court applied an amorphous legal standard "centered on" determining whether the transaction "was merely a device to avoid tax liability" –notwithstanding that "it actually occurred and technically complied with the tax code." Pet. App. 14a. It concluded that Sovereign's cross-border transaction was such "a device" because it was "profitless." *Id.* at 16a. It was "profitless," however, only because the court *included* the foreign taxes Sovereign paid as an *expense* of the transaction and *excluded* the FTCs it sought from the transaction's *revenue*. In other words, rather than evenhandedly counting either *all* tax effects or *no* tax effects in assessing whether the transaction had profit independent of its tax effects, the First Circuit *selectively* counted *some* tax effects: foreign taxes paid but not the credits earned by paying those same taxes. That methodology conflicts with decisions in the Fifth and Eighth Circuit in *Compaq Computer Corp. v. Commissioner*, 277 F.3d 778 (5th Cir. 2001), and *IES Indus., Inc. v. United States*, 253 F.3d 350 (8th Cir. 2001). It also stacks the deck against finding a transaction profitable and directly affects the

viability of a wide range of international transactions by U.S. companies.

The First Circuit's holding deepens a circuit conflict involving five courts of appeals. The First Circuit followed earlier decisions of the Federal Circuit and Second Circuit in holding that foreign tax payments are expenses when assessing the profitability of a transaction under the economic substance doctrine. *Salem Financial, Inc. v. United States*, 786 F.3d 932, 946-949 (Fed. Cir. 2015); *Bank of New York Mellon Corp. v. Comm'r*, 801 F.3d 104, 118, 124 (2d Cir. 2015). These courts specifically acknowledged that their holdings conflicted with the earlier decisions of the Fifth and Eighth Circuits in *Compaq* and *IES*. Although this Court denied review in *Salem Financial,* No. 15-380, and *Bank of New York Mellon Corp.*, No. 15-572 (*cert. denied* Mar. 7, 2016), this case presents a better vehicle than the previous petitions, and the Government's prior reasons for denying scrutiny have been invalidated by subsequent developments.

The contrast between the First Circuit's decision in this case and *Summa Holdings, Inc. v. Comm'r of Internal Revenue*, 16-1712, 2017 WL 631663 (6th Cir. Feb. 16, 2017), demonstrates that the circuit split is fundamental and entrenched. It reflects broader disagreement among the appellate courts about the meaning and application of so-called anti-abuse doctrines and the role of the federal courts in promulgating judge-made law under a detailed statutory scheme. "If the government can undo transactions that the terms of the Code expressly authorize, it's fair to ask what the point of making

these terms accessible to the taxpayer and binding on the tax collector is." *Summa Holdings, Inc.*, 2017 WL 631663, at *1. This Court's plenary review is amply warranted.

A. The Statutory Scheme of Foreign Tax Credits Under Section 901 of the Internal Revenue Code.

The United States taxes U.S. taxpayers' worldwide income, including foreign-source income that is also taxed by a foreign country. 26 U.S.C. § 61(a). Absent some offsetting tax credit, a U.S. taxpayer earning income overseas would pay tax on that income twice — once to the foreign country, and once to the United States. *PPL Corp. v. Commissioner*, 133 S. Ct. 1897, 1901 n.2 (2013). Recognizing that "double taxation" discourages international commerce, Congress enacted the foreign tax credit ("FTC") in 1918. As this Court has recognized, the "primary design" of the 1918 foreign tax credit "was to mitigate the evil of double taxation." The FTC prevents double taxation by authorizing U.S. taxpayers to take a dollar-for-dollar credit offsetting their U.S. income taxes by amounts paid as income tax to a foreign country on foreign-source income. 26 U.S.C. § 901(b) (Pet. App. 61a-63a); *see also id*. § 27(a).

The claiming of FTCs is the subject of extensive and detailed government regulation. Statutes and regulations prescribe that foreign tax credits are available only in carefully delineated circumstances and only up to designated limits. Bittker & Eustice, *Federal Income Taxation of Corporations and Shareholders* ¶15.21[1][a] (7th ed. Supp. 2014); *see*

26 U.S.C. § 904(a). The statutory and regulatory provisions create a highly-reticulated regime that is exceedingly complicated, but necessary to encourage economically desirable cross-border investment.

B. Factual Background Of This Case.

Sovereign was a U.S.-based commercial bank that entered into a transaction known as a Structured Trust Advantaged Repackaged Securities ("STARS") with U.K.-based Barclays Bank. Pet. App. 7a. STARS included a loan from Barclays to Sovereign. Barclays designed STARS so that the loan also created tax benefits for Barclays under U.K. law.

The key aspects of STARS were as follows:

Sovereign contributed approximately $6.7 billion of income-producing assets to a Trust with a U.K.-based trustee, roughly $1.3 billion of which served as collateral for the loan. *Id.* The Trust's income was subject to U.K. income tax, which Sovereign paid, through the Trust. Pet. *Id*. At the same time, Sovereign reported the Trust's income on its U.S. federal income tax return (as required), and claimed U.S. foreign tax credits in the amount of the tax payments remitted by the Trust to the U.K. government. Sovereign's entitlement to these U.S. foreign tax credits is at issue in this case. *Id*.

Barclays made the loan to Sovereign by acquiring an interest in the Trust for $750 million at the Trust's inception, and acquiring an additional $400 million interest one year later. Sovereign was required to repay the $1.15 billion in five years. Pet.

App. 7a-8a. Sovereign made interest payments to Barclays on the $1.15 billion. Pet. App. 8a. At the same time, Barclays set off Sovereign's interest payment against a separate payment from Barclays to Sovereign called the "Bx" or "Barclays Payment." *Id.* The amount of the Bx was based on Barclays' expected U.K. tax credits, which are described below. Pet. App. 9a.

The Trust was subject to a 22% U.K. tax on its income, which Sovereign, as the owner of the Trust assets, paid. Separately, Barclays ownership interest in the Trust subjected it to U.K. tax at a rate of 30% on income distributed from the Trust to it. The U.K., however, permitted Barclays to take a 22% credit to avoid being taxed on the Trust income twice, reducing Barclays's net tax liability to 8% of the Trust's distributable income. Pet. App. 9a. If the Trust earned $100, for example, Barclays would owe $8 in U.K. tax absent any other benefits.

The transaction afforded Barclays additional U.K. tax benefits in the form of a deduction that eliminated its 8% tax liability and generated a net U.K. tax benefit. This tax benefit arose from Barclays receipt of monthly distributions from the Trust, which it recontributed back to the Trust (as required by the transaction documents). Pet. App. 9a. Using as an example $100 of Trust income distributed to Barclays, Barclays contributed back to the Trust $78.[2] It was entitled to a 30% deduction for the amount it contributed to the Trust, or $23.40. This deduction more than offset Barclays' $8 U.K.

[2] The other $22 was income tax retained by the U.K.

tax liability, yielding a net after-tax benefit of $15.40. Pet. App. 9a-10a. U.K. law also allowed Barclays to deduct the Bx payment to Sovereign, for an additional benefit to Barclays of $3.30. Pet. App. 10a.

By engaging in the STARS transaction, Sovereign transferred some of its income tax liability from the United States to the United Kingdom. It secured a loan of $1.15 billion and it was paid the Bx, which effectively reduced its lending costs. Barclays, in turn, secured U.K. tax benefits it could use to offset income unrelated to the transaction.

C. The District Court Proceedings

In 2009, the IRS issued a Notice of Deficiency, disallowing Sovereign's foreign tax credits.[3] The IRS did not challenge Sovereign's compliance with the statutory and regulatory requirements governing the foreign tax credit, asserting instead that the STARS transaction lacked "economic substance." Pet. App. 28a.

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[3] The IRS also disallowed deductions for the loan interest Sovereign paid to Barclays. The district court held that the loan component of the STARS transaction had economic substance – "it was a real loan," Pet. App. 45a – so Sovereign was entitled to a refund of the loan interest deduction disallowed by the Government. The Government did not appeal the district court's conclusion that loan interest was deductible. Sovereign's entitlement to refund of its loan interest deduction is no longer at issue. Pet. App. 6a n.4.

Sovereign paid the assessment and sued for a refund in the United States District Court for the District of Massachusetts. Although STARS was structured as a single, integrated financing transaction, the Government argued it should be bifurcated into separate trust and loan transactions. Though Sovereign disagreed with that characterization, it accepted a bifurcated treatment for purposes of summary judgment and appeal. Pet. App. 6a n.4, 28a n.3. This petition addresses the decision regarding the economic substance of the trust.

In January 2016, the district court entered a final judgment in favor of Sovereign. The judgment arose from two separate orders, each rejecting different Government arguments as to why the Trust component of the STARS transaction was profitless and therefore lacked economic substance. Pet. App. 24a, 41a.[4]

In support of its motion for summary judgment, the Government argued the transaction lacked economic substance because it was profitless, and it was profitless because the U.K. tax paid by Sovereign should be considered a pre-tax expense of the transaction, rather than a "tax," while the U.S.

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[4] In an October 2013 order granting Sovereign partial summary judgment, the district court rejected the government's argument that the Bx payment was a "tax effect" rather than income. The First Circuit did not address this question and it is not at issue in this petition. This petition addresses the First Circuit's reversal of the district court's November 2015 order granting summary judgment to Sovereign.

foreign tax credit it received should be considered a "tax" rather than revenue. Pet. App. 45a-49a. Tellingly, however, the Government's own experts did not treat foreign tax as an expense when calculating the pre-tax profit of the transaction. CA1 JA75-76. In fact, one of the Government's experts admitted that the pre-tax profit test should not include foreign taxes. CA1 JA84.

The district court rejected the Government's summary judgment argument as "circular" and a "bootstrap position" that "assumes what it seeks to prove: the foreign tax credit should be ignored for purposes of the profitability analysis." Pet. App. 48a-49a. Relying on *Compaq Computer Corp. v. Commissioner*, 277 F.3d 778, 785 (5th Cir. 2001), the district court held that "to be consistent" the economic substance analysis "should either count all tax effects or not count any of them." "To do otherwise 'is to stack the deck against finding the transaction profitable.'" Pet. App. 48a (quoting *Compaq*, 277 F.3d at 785).

Looking through the government's persistent "rhetorical flourishes" and "undertone of indignation," the district court concluded that "[w]hat seems to bother the government is not so much that Sovereign does not qualify for foreign tax credits as that it does not deserve them." Pet. App. 47a, 58a-59a. By turning Sovereign's entitlement to tax credits into "as much a matter of moral judgment as legal," the government ran a "serious risk" of creating a legal standard that "becomes a kind of smell test, with the judge's nose ending up the crucial determinant of the outcome." *Id.* at 58a-59a.

Here, the district court concluded, the government's argument for disallowing Sovereign's FTCs was "visceral" rather than "analytical." Pet. App. 59a. According to the district court, the IRS took an approach that was "fanciful," and "ma[d]e no sense," aside from its "utility for the particular case at hand." *Id.* at 53a, 59a. Ultimately, for the district court, this case "illustrate[d]" that "the judicial anti-abuse doctrines—whether substance over form or economic substance—can themselves be susceptible to abuse." *Id.* at 57a. "The characterization the government uses to condemn Sovereign's actions in the STARS transaction is not limited to the STARS transaction." *Id.* at 54a. Rejecting the government's argument as based on "novel principles of judgment," the court granted summary judgment for Sovereign. *Id.* at 59a.

D. The Decision Below.

The First Circuit, exercising de novo review, Pet. App. 15a, reversed. The Court of Appeals began by opining that "the economic substance test guards against abuse of loopholes that Congress and the IRS have not anticipated." Pet. App. 11a n.7. The First Circuit opined that "when the challenged transaction has no prospect for pre-tax profit[,] then it is an act of tax evasion that, even if technically compliant, lies outside of the intent of the Tax Code and so lacks economic substance." *Id.* at 15a.

The First Circuit treated the economic substance test as authorizing a court to decide for itself whether a transaction is "merely a device to avoid tax liability." Pet. App. 14a. The Court of Appeals accepted the Government's contention that

Sovereign's U.K. tax payments should be "factored into the pre-tax profitability calculation." Pet. App. 17a. It then concluded that the "Trust transaction is plainly profitless" because "[w]hen the U.K. taxes are recognized as expenses, there is no pre-tax profit . . . ." *Id.* at 17a n.11.

The court stated that its decision to treat Sovereign's foreign tax payments as transaction expenses "mirrors that of the Federal Circuit" in *Salem Financial v. United States,* 736 F.3d 932 (Fed. Cir. 2015). Pet. App. 16a. The court acknowledged contrary holdings from the Fifth and Eighth Circuits in *Compaq Computer*, 277 F.3d at 785 and *IES Indus., Inc. v. United States*, 253 F.3d 350 (8th Cir. 2001), which had, in turn, relied on this Court's decision in *Old Colony Trust Co. v. Commissioner*, 279 U.S. 716 (1929) for the conclusion that foreign tax payments should not be considered pre-tax expenses. Pet. App. 17a n.11.

The court chose to follow the Federal Circuit over the Fifth and Eighth Circuits because "[*Compaq* and *IES*] did not analyze STARS transactions and so are distinguishable factually." *Id.* And "*Old Colony* did not involve foreign taxes and says nothing about whether foreign tax liability may ever be considered an expense." *Id.*

REASONS FOR GRANTING THE WRIT

The First Circuit's decision warrants this Court's plenary review for two reasons. First, there is a circuit conflict regarding the treatment of foreign taxes as "expenses" under the economic substance test. The First Circuit joined the Federal Circuit and Second Circuit in holding that foreign taxes should be treated as expenses – while domestic U.S. taxes are not. The difference in treatment means that the same transaction could be deemed a "sham" if conducted abroad but not a sham if undertaken at home. The Fifth and Eighth Circuits have adopted the contrary rule.

Second, this Court's review is warranted because the circuit conflict arises out of a broader disagreement among the lower courts regarding the underlying premises of the economic substance doctrine.

I. There Is A Circuit Conflict On How To Account for Foreign Taxes Paid When Assessing A Transaction's Economic Substance.

There is a clear division of authority in the nation's federal appellate courts regarding the application of the economic substance doctrine to cross-border transactions. The Second Circuit in *Bank of N.Y. Mellon*, the Federal Circuit in *Salem Financial*, and the First Circuit in this case have held that in evaluating the profitability of a cross-border transaction, courts must *include* foreign tax as an expense of the transaction, but must *exclude* U.S. tax credits that would flow from those foreign

taxes. Pet. App. 17a n.11 ("[W]hen the U.K. taxes are recognized as expenses, there is no pre-tax profit, and the Trust transaction lacks a cardinal feature of an economically substantial transaction: a reasonable prospect of pre-tax profit.").

This hybrid approach, in which foreign taxes count, but U.S. credits do not, is directly opposed to decisions by the Fifth and Eighth Circuits, which held that neither foreign taxes nor resulting U.S. credits should be taken into account when assessing a transaction's profitability. *See also Bank of N.Y. Mellon,* 801 F.3d 124 ("[W]e agree with the Federal Circuit in *Salem* and disagree with decisions of the Fifth and Eighth Circuits (*Compaq* and *IES*, respectively.)"; Pet. App. 17a n.11 ("Sovereign and the district court rely heavily on *Compaq* and *IES* for the proposition that foreign taxes should not be treated as expenses. . . . We agree with the *Salem* court's analysis of this issue as to the Trust transaction.") (citing *Salem Financial*, 786 F.3d at 947-49).

In the transactions at issue in *Compaq* and *IES*, U.S. companies bought shares in Dutch companies just before the dividend record date (purchasing stock that was pregnant with immediately forthcoming dividends), collected the dividend, and then immediately sold the shares at a loss. The companies claimed foreign tax credits for taxes they paid to the Netherlands to offset their U.S. tax on the dividend income, and used the loss on the sale of shares to offset unrelated capital gains. *See Compaq*, 277 F.3d at 779-780; *IES*, 253 F.3d at 352.

On appeal, both the Fifth and Eighth Circuits held that the gross dividend, not the dividend net of foreign taxes, should have been used to determine whether the transaction was profitable. ("Because the entire amount of the . . . dividends was income to IES, the . . . transactions resulted in a profit, an economic benefit to IES."); *Compaq*, 277 F.3d at 786. As the Fifth Circuit explained: if the tax had been paid to the United States rather than the Netherlands, "there would have been no argument that [the gross amount] was not income to [the taxpayer]"; and it was "irrelevant" "[t]hat the tax was imposed by the Netherlands rather than by the United States." *Compaq*, 277 F.3d at 783-784. The Eighth Circuit employed similar reasoning. "Pre-tax income is pre-tax income regardless of the . . . origin of the tax." *Id*. at 784. When a taxpayer earns income subject to a foreign tax, "the economic benefit to [the taxpayer] [is] the amount of . . . gross [income] before the foreign taxes [are] paid." *IES*, 253 F.3d at 354. That situation "is no different from an employer withholding and paying to the government income taxes for an employee: the full amount before taxes are paid is considered income to the employee." *Id*. (citing *Old Colony Trust Co.*, 279 U.S. at 729).

In *Compaq*, the Fifth Circuit criticized the IRS's approach—the same approach the First Circuit adopted here. The Fifth Circuit noted that "counsel for the Government admitted that he had found no case supporting the proposition that foreign tax on a transaction should be treated as an expense." 277 F.3d at 785 n.7. The Fifth Circuit took issue with the IRS for "treat[ing] the [foreign] tax as a cost of the

transaction, but . . . not treat[ing] the corresponding U.S. tax credit as a benefit of the transaction." *Id.* at 782. That "half pre-tax, half after-tax calculation" of profit was an unfair and "curious method of calculation." By "count[ing]" taxes "only when they subtract from cash flow," the IRS "stack[s] the deck against finding the transaction profitable." *Id*. at 785. "To be consistent," the court explained, "the analysis should either count all tax law effects or not count any of them." *Id*.

In this case, the First Circuit followed the approach the Fifth and Eighth Circuits rejected. It concluded the transaction lacked potential for profit because "every $1 the Trust transaction earns through the Bx payment costs $2 from the transaction costs of subjecting the Trust transaction to U.K. tax." Pet. App. 17a. Under the holdings in *Compaq* and *IES*, the foreign taxes paid to the U.K. would not be considered in the profitability calculation. The First Circuit's assertion that *Compaq* and *IES* "did not analyze STARS transactions and so are distinguishable factually," Pet. App. 17a n.11, simply does not address the Fifth Circuit's cogent criticism that the First Circuit's approach "stacks the deck against finding the transaction profitable." *Compaq*, 277 F.3d at 785.

Moreover, the First Circuit's adoption of the Federal Circuit's reasoning (*see* Pet. App. 17a n.11 ("We agree with the *Salem* court's analysis of this issue as to the trust transaction.")) undermines any suggestion that the different outcomes arise from different facts: the Federal Circuit concluded *not* that *Compaq* and *IES* were distinguishable, but that

they were wrongly decided because they failed to treat foreign taxes as expenses. The Federal Circuit opined that "[t]he *Compaq* and *IES* transactions produced no real economic profit." *Salem*, 786 F.3d at 948. The Federal Circuit emphasized that any apparent profit in those cases was a result of including in income the amount of the dividend "without taking into account the foreign taxes paid on the dividend." *Id.*

In short, the transactions in *Compaq* and *IES* would have been decided differently had they arisen in the First, Second, or Federal Circuits. And, conversely, if this case had arisen in the Fifth or Eighth Circuits, the foreign tax expense incurred by Sovereign would have been excluded from the calculation of the transaction's profit, and the trust transaction would have been deemed to generate substantial pre-tax profit. It is intolerable for the availability of federal tax credits to turn on the fortuity of the circuit in which the taxpayer resides. This Court should grant certiorari and resolve this circuit split.

II. The Circuit Split Reflects Broader Disagreement Among The Lower Courts And Undermines The Certainty Required For Fair Tax Administration.

This Court's plenary review of the acknowledged circuit split is amply warranted because of the broader uncertainty within the lower courts as to the economic substance doctrine's underlying premises. The circuits are divided on the basic question of whether anti-abuse doctrines like economic substance are equitable doctrines or tools of

statutory construction. This disagreement, in turn, results in different circuits identifying the doctrine's elements differently and applying inconsistent tests to determine when a transaction lacks economic substance. The divergent results exemplified here are not unique, but derive from underlying inconsistencies in how the doctrine is applied. Disagreement on the fundamental contours of the economic substance doctrine undermines uniformity in the administration of the federal tax system, which both this Court and the executive branch enforcement authorities have long recognized as a fundamental necessity.

A. The Circuit Split On Foreign Tax Treatment Reflects Broader Uncertainty About Core Questions Underlying the Anti-Abuse Doctrines.

One leading tax treatise aptly describes the economic substance doctrine as "exquisitely uncertain." Bittker & Lokken, *Federal Taxation of Income, Estates, and Gifts* ¶4.3.1 & n.8 (2013). Another commentator explains that it is "applied differently from circuit to circuit and sometimes inconsistently within circuits." *Modern Tax Controversies*, 957 Practicing Law Inst. at 478–35 (2012). A tax court judge concurs, explaining that a "free-standing approach to identifying economic substance, . . . empower[s] the courts (or the Commissioner) to tailor the statute to unforeseen circumstances." James S. Halpern, *Putting The Cart Before The Horse: Determining Economic Substance Independent Of The Language Of The Code*, 2010 VA. TAX. REV. 327, 337-38. Even the Treasury Department has recognized these concerns. It

reported that the economic substance and related anti-abuse doctrines are "inherently subjective," that "courts have applied them unevenly," and that "a great deal of uncertainty exists as to when and to what extent these standards apply, how they apply, and how taxpayers may rebut their assertions." Department of the Treasury, *The Problem of Corporate Tax Shelters: Discussion, Analysis, and Legislative Proposals* 94 (July 1999).

The lower courts have expressed similar views. The Second Circuit has opined that "[t]he law of economic substance, it must be said, is not a model of clarity." *United States v. Coplan*, 703 F.3d 46, 91 (2d Cir. 2012). The Sixth Circuit (per Sutton, J.) recently explained that the confusion arises because "the line" the anti-abuse doctrines attempt to demarcate "between disregarding a too-clever-by-half accounting trick and nullifying a Code-supported tax-minimizing transaction can be elusive." *Summa Holdings, Inc. v. Comm'r of Internal Revenue*, No. 16-1712, 2017 WL 631663, at *5 (6th Cir. Feb. 16, 2017). The doctrine's "elusive[ness]" has led to fundamental disagreements among the circuits.

1. The Appellate Courts Disagree About Whether Anti-Abuse Doctrines Are Independent Of The Tax Code Or Canons for Construing It.

The circuits disagree on the basic nature of the economic substance doctrine. There is a clearly articulated split between those courts that consider the doctrine a judge-made common law rule, and those that apply it as a traditional tool of statutory

construction. The disagreement on the character of the doctrine leads to conflicting approaches to assessing the economic substance of indistinguishable transactions with correspondingly divergent outcomes.

The three appellate courts that have adjudicated economic substance challenges to STARS transactions have applied the economic substance doctrine as a stand-alone requirement that must be satisfied independent of – and in addition to – any requirements imposed by the Internal Revenue Code. As the Federal Circuit explained in *Salem Financial*, "'economic substance is a prerequisite to the application of any Code provision allowing deductions.'" 786 F.3d at 941 (quoting *Coltec Indus., Inc. v. United States*, 454 F.3d 1340, 1356 (Fed. Cir. 2006)). The Second Circuit, disallowing FTCs in *Bank of New York Mellon*, took the same approach. "The economic substance doctrine exists to provide courts a 'second look' to ensure that particular uses of tax benefits comply with Congress's purpose in creating that benefit." *Bank of N. Y. Mellon*, 801 F.3d at 113.

In the decision below, the First Circuit adopted the Federal Circuit's approach to evaluating economic substance. Pet. App. 6a. Notwithstanding the First Circuit's *pro forma* assertion that the economic substance doctrine should effectuate legislative intent, Pet. App. 8a, the court never examined any of the specific statutory or regulatory provisions implicated by STARS. Instead, like the Federal Circuit and Second Circuit, the First Circuit devoted its analysis to the nebulous task of

"'assess[ing] the transaction's economic reality.'" Pet. App. 16a. (quoting *Salem Financial*, 786 F.3d at 948).[5]

A recent decision by the Sixth Circuit, however, joined an earlier D.C. Circuit decision in rejecting this approach. In *Summa Holdings, Inc. v. Comm'r,* 2017 WL 631663, the court explained that the economic substance doctrine is neither a "prerequisite" nor a judicial "second look" that can be applied independent of the Code. "It's one thing to permit the Commissioner to recharacterize the economic substance of a transaction—to honor the fiscal realities of what taxpayers have done over the form in which they have done it. But it's quite another to permit the Commissioner to recharacterize the meaning of statutes—to ignore their form, their words, in favor of his perception of their substance." *Id.* at *3.

In *Summa Holdings Inc.*, the government relied on the "substance-over-form" doctrine to recharacterize a company's commission payments to its subsidiary as dividends to its shareholders, resulting in an unpaid income tax liability. 2017 WL 631663, at *3. The Tax Court upheld the assessment, but the Sixth Circuit reversed. It concluded that the transaction complied with the statutory requirements and was consistent with their purpose.

[5] The Eleventh Circuit also follows this approach, treating judicial anti-abuse doctrines as an overlay on the Code. "The analysis of whether something is a sham, then, must occur before analysis of the [statutory provisions]." *Kirchman v. Comm'r*, 862 F.2d 1486, 1491 (11th Cir. 1989).

Id. at *6. Consequently, the government lacked authority to recharacterize the transaction in the guise of "effectuating" the underlying purpose of the Code.

> Keep in mind what is at issue in each of these cases: the meaning of words in the Code like "income," "reorganization," and "debt," or as here words like "contribution" or "dividend." It's fine—indeed essential—to attend to economic realities in deciding whether one of these terms covers a transaction. But it's odd to reject a Code-compliant transaction in the service of general concerns about tax avoidance. Before long, allegations of tax avoidance begin to look like efforts at text avoidance.

Id. at *6.

The Sixth Circuit's understanding of the economic substance doctrine as a tool of statutory construction is shared by the D.C. Circuit. In *Horn v. C.I.R.,* 968 F.2d 1229 (D.C. Cir. 1992), the D.C. Circuit held that losses incurred by taxpayers in connection with straddle transactions were allowed under the Tax Reform Act of 1984, reversing the Tax Court's decision that the transactions in which the taxpayers engaged were "economic shams." The D.C. Circuit opined that:

> The principal problem that we find with the Commissioner's argument is that it takes the sham transaction doctrine too far. Although useful in determining congressional intent and in avoiding results unintended by tax

> code provisions, the doctrine cannot trump the plainly expressed intent of the legislature. In this case, the plain meaning of the statute authorizes the claimed deductions, and the Commissioner has utterly failed to provide any other colorable interpretation.

Id. at 1231. In a footnote, the D.C. Circuit expressly disagreed with decisions by the Second, Third, Fourth, Ninth, and Eleventh Circuits because those circuits had bifurcated their analysis: first looking at whether the transaction satisfied the economic substance doctrine and applying the statutory terms only to those transactions with sufficient *ex ante* "substance."[6] The D.C. Circuit opined that it was "at a loss to understand the Commissioner's suggestion,

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[6] The court in *Horn* identified cases from five circuits, which had held that the economic substance doctrine must be satisfied in addition to the statutory requirements of the Code. 968 F.2d at 1238 n.12 (identifying disagreement with *Lerman v. Comm'r*, 939 F.2d 44, 52 (3d Cir. 1991) (holding that "economic substance is a prerequisite to the application of any Code provisions"); *Friedman v. Comm'r*, 869 F.2d 785, 791 (4th Cir. 1989) (holding statutory provision is "inapplicable to this case because the transactions at issue constitute economic shams"); *United States v. Atkins*, 869 F.2d 135, 139 (2d Cir. 1989) (declining to apply statutory criteria to "sham transactions"); *Kirchman v. Comm'r*, 862 F.2d 1486, 1491 (11th Cir. 1989) ("The analysis of whether something is a sham, then, must occur before analysis of the [statutory criteria]"); *Sochin v. Comm'r*, 843 F.2d 351, 353 n.6 (9th Cir. 1988) (applying bifurcated standard where court must first "determine[ ] that the transaction is itself bona fide, i.e. that it is not a sham" and only then apply the statutory criteria).

adopted by several courts, that the sham transaction doctrine applies independently of [26 U.S.C. §] 108." *Id*. at 1238. The D.C. Circuit concluded that "the sham transaction doctrine is simply an aid to identifying tax-motivated transactions that Congress did not intend to include within the scope of a given benefit-granting statute." *Id*.

The First Circuit's formulation of the "sham transaction" doctrine is thus inconsistent with the approaches of both the Sixth Circuit and the D.C. Circuit.

2. The Widely Divergent Legal Standards Applied By The Lower Courts Produce Outcome-Determinative Differences.

Because the appellate courts disagree on the basic contours of the doctrine, they have devised distinct legal standards for applying the doctrine. These different legal standards are outcome-determinative, in the sense that they produce different outcomes in comparable factual situations.

Those courts that apply the economic substance doctrine as a self-standing common law rule have created a fact-based legal standard directed at discerning the "practical economic effects" of the transaction. *James v. Comm'r*, 899 F.2d 905, 908-09 (10th Cir. 1990). This is an unbounded and amorphous analysis, the goal of which is to ascertain whether the transaction "lack[ed] economic reality." *Coltec Indus., Inc.*, 454 F.3d at 1355. The transaction's objective profitability and the taxpayer's purpose are merely factors, among others, in a wide-ranging inquiry. *See ACM P'ship v.*

Comm'r, 157 F.3d 231, 247 (3d Cir. 1998) (objective effect and subjective purpose of the transaction "do not constitute discrete prongs of a rigid two-step analysis, but rather represent related factors both of which inform the analysis of whether the transaction had sufficient substance, apart from its tax consequences, to be respected for tax purposes."); *Bank of N.Y. Mellon*, 801 F.3d at 115 ("we employ a 'flexible' analysis where both prongs are factors to consider in the overall inquiry into a transaction's practical economic effects").

By contrast, the Sixth and D.C. Circuits apply a text-bound analysis, consistent with other canons of statutory construction, to discern economic substance. As Judge Sutton explained: "If the government can [under the economic substance doctrine] undo transactions that the terms of the Code expressly authorize, it's fair to ask what the point of making these terms accessible to the taxpayer and binding on the tax collector is." *Summa Holdings, Inc.*, 2017 WL 631663, at *1. Thus, the Sixth Circuit, applying the doctrine as a tool of statutory construction, does not seek the inchoate "economic reality" of a transaction, or attempt to divine the "'overarching' purpose of the Code." *Id.* at *7. Rather, recognizing that "purpose must be grounded in text," *id.*, the Sixth Circuit looks to the purpose behind the specific provisions of the Code that the government seeks to override.

In *Summa*, for example, the Sixth Circuit recognized that the function of the specific code provisions in question was to "enable tax savings," and it rejected the government's attempt to "place ad

hoc limits on them by invoking a statutory purpose . . . that has little relevance to the text-driven function of these portions of the Code . . . .” *Id*. Similarly, the D.C. Circuit in *Horn* reversed a Tax Court decision disallowing deductions under the sham transaction doctrine, and explained that the transaction’s validity did not turn on its “practical economic effects,” but rather on its consistency with the statute under which it was permitted. “[W]hile following the parties’ assumptions that the transactions at issue here were not entered into for economic profit and that no evidence has shown a nontax business purpose, we analyze section 108 to see whether it nonetheless authorizes the claimed deductions.” *Horn*, 968 F.2d at 1238. The court concluded that the specific statutory provision at issue reflected Congress’s intent to permit transactions like the one at issue. *Id.*

Thus, the different legal standards applied by the circuits have outcome-determinative effects.

3. The Circuit Split On The Treatment Of Foreign Taxes Reflects The Broader Disagreements About the Nature Of Anti-Abuse Doctrines And The Proper Legal Standard.

The circuit split on the treatment of foreign taxes is a consequence of the broader disagreement among the circuits as to the purpose of the economic substance doctrine and its elements. The court below “agree[d] with the Federal Circuit that the Trust transaction is profitless” because the foreign tax payments were expenses that exceeded any potential profits. Pet. App. 16a. The same factors on which the

court relied to characterize Sovereign's foreign tax payment as an expense lead to the exact opposite conclusion if the economic substance doctrine is applied as a canon of statutory construction instead of a freestanding "prerequisite" to applying the Code's terms.

Defending its characterization of the foreign tax payment as an expense, the court stated:

> Barclays agreed to bear half of [Sovereign's] U.K. tax expense under the transaction in exchange for an opportunity to claim substantial U.K. tax benefits for itself . . . . [Sovereign], on the other hand, benefitted by claiming a foreign tax credit equal to the entire amount of the Trust's U.K. taxes while getting back one-half of the U.K. tax from Barclays. Absent those tax advantages, the STARS transaction would never have occurred.

Pet. App. 19a (quoting *Salem Financial*, 786 F.3d at 952). The court thus relied on the fact that (a) Sovereign did not bear the full economic burden of the U.K tax because it got "back one-half . . . from Barclays," and (b) Barclays was able to secure substantial tax benefits for itself by incurring Sovereign's U.K. tax obligation. The court opined that this structure "did not advance the Tax Code's interest in providing foreign tax credits," *id.* at 20a, because "Sovereign subjected its property and income to U.K. taxation only because it anticipated it could avoid U.S. taxes through the resulting U.S. tax credit." *Id.* at 19a-20a.

A textual approach, incorporating the "subtleties" and "discrete rules" of the FTC at the appropriate granular level shows that the factors on which the court relied when characterizing the foreign tax payment as an expense – that Barclays bore the burden of Sovereign's U.K. tax, and that Barclays was able to secure U.K. tax benefits by doing so – are consistent with, indeed contemplated by the FTC regime. *Summa Holdings, Inc.*, 2017 WL 631663, at *7. They therefore cannot, consistent with legislative intent, preclude Sovereign's entitlement to those credits.

First, the foreign tax credit regime contains a specific rule that the identity of the party bearing the economic burden of a foreign tax is not relevant to determining who is entitled to the FTC. The "technical taxpayer" rule gives the FTC to the taxpayer legally liable for the tax, rather than the party that paid it. "Tax is considered paid by the taxpayer even if another party to a direct or indirect transaction with the taxpayer agrees, as a part of the transaction, to assume the taxpayer's foreign tax liability." Treas. Reg. § 1.901-2(f)(2)(i) (Pet. App. 36a, 96a-98a); *see also* James M. Peaslee, *Economic Substance Test Abused*: Notice 98-5 and the Foreign Law Taxpayer Rule, Special Report, Tax Notes (TA), 79, 101 (Apr. 6, 1998) ("[T]he section 901 regulations and case law establish unambiguously that bearing the burden of a tax is neither a necessary nor sufficient condition for claiming a credit."); Shannon Weeks McCormack, *Tax Shelters And Statutory Interpretation: A Much Needed Purposive Approach,* 3 UNIV. OF ILL. L. REV. 697, 765 (2009) ("When one looks at the foreign tax credit regime, it is by no

means clear . . . that there is a purpose to restrict foreign tax credits to taxpayers who have economically borne them."). Thus, one core fact on which the First Circuit relied to conclude that the payment of foreign taxes was a transaction expense, and therefore disallow FTCs, is a fact that the FTC regime expressly contemplates, directing that a party is still entitled to FTCs for foreign taxes even if it does not bear the economic burden of that tax.

Similarly, in finding Sovereign's foreign tax payments to be a transaction expense, the First Circuit gave substantial weight to Barclays's ability to "claim substantial U.K. tax benefits for itself," Pet. App. 19a (quoting *Salem Financial*, 786 F.3d at 952). But that fact, too, is contemplated and addressed by the statutory and regulatory scheme. Section 901(i), 26 U.S.C. § 901(i) (Pet. App. 30a, 67a) and Treasury Regulation 1.901-2(e) (Pet. App. 81a), codify the "subsidy rule," which explains exactly when tax benefits provided by a foreign government will preclude a taxpayer from seeking FTCs. The government conceded that the "subsidy rule" did not apply in this case; that is, it acknowledged that the tax benefits Barclays secured did not impact Sovereign's entitlement to FTCs under the statutory provision directly addressing the issue. Pet. App. 32a; Weeks, *supra*, at 769 (arguing that using economic substance doctrine to "look at other cash flows of the deal to see if the foreign tax was recouped anywhere within the transaction" is "not rooted in the purposes of the law").

The First Circuit undermined its position by pointing to an IRS regulation proposed in 2007 and

finalized in 2011 prohibiting STARS transactions, but not retroactively. Pet. App. 3a. The very existence of that *prospective-only* regulation is telling. The First Circuit construed the judge-made economic substance doctrine to reach the same result on a *retroactive* basis, even though the regulation expressly did *not* apply to the transaction in this case. The regulation demonstrates the impropriety of stretching the economic substance doctrine, because the IRS already possesses ample rulemaking authority in this area.[7]

Thus, the circuit split on the treatment of foreign taxes arises from deeper conflicts over the nature and scope of judicial anti-abuse doctrines. In this case, the First Circuit's nontextual approach converted the economic substance doctrine into "a warrant to search through the Internal Revenue Code and correct whatever oversights Congress happens to make or redo any policy missteps the legislature happens to take." *Summa Holdings, Inc.*, 2017 WL 631663, at *8. A textually grounded approach, by contrast, recognizes that "the best way

[7] An administrative regulation promulgated by an expert agency enjoys many advantages over a judge-made rule, as the district court noted in this case. Pet. App. 35a ("If there were to be such a new principle adopted, and it would be a new principle, it would be better done through the legislative and rulemaking processes where the focus is broad, rather than through adjudication where the focus is particular and possibly outcome-driven."). The regulation cited by the First Circuit is an intricate measure, with detailed rules and twelve examples illustrating its operations. A court could not decree anything resembling such a rule.

to effectuate Congress's nuanced policy judgments is to apply each provision as its text requires—not to elevate purpose over text when taxpayers structure their transactions in unanticipated tax-reducing ways." *Id.* at *7.

The circuit split on the treatment of foreign expenses is one symptom of a deeper and broader conflict over the nature and purpose of judicial anti-abuse doctrines.

B. Divergent Applications Of Anti-Abuse Doctrines Among The Circuits Undermines Certainty In The Tax Law.

This Court has long recognized the particular need for uniformity in the administration of the federal tax system. *See, e.g.*, *Aquilino v. United States*, 363 U.S. 509, 514 (1960); *Thor Power Tool Co. v. Commissioner*, 439 U.S. 522, 543 (1979) ("[T]ax law . . . can give no quarter to uncertainty."). In advocating for grants of certiorari, the Solicitor General has likewise underscored the "significant governmental and public interest in the uniform administration of federal tax law." U.S. Br. 20, *Beard v. Commissioner*, No. 10-1553 (July 2011) (recommending certiorari); *see also* U.S. Br. 14, *PPL Corp. v. Commissioner*, No. 12-43 (Sept. 2012) (recommending certiorari where circuit conflict "implicate[d] the important federal interest in uniform enforcement of the federal tax laws"). Without this Court's intervention, "inequalities in the administration of the revenue laws" will persist. *Commissioner v. Sunnen*, 333 U.S. 591, 599 (1948).

These disparities are important because the First Circuit's rule would use the economic substance doctrine to negate rather than promote congressional intent. Treating foreign taxes as pre-tax "expenses" runs afoul of the fundamental purpose underlying the FTC regime—i.e., that foreign taxes and U.S. taxes should be treated the same for U.S. tax purposes, so that taxpayers are indifferent as to which they incur. Congress enacted the FTC to "encourage[] foreign investment abroad" by ensuring that "a dollar anywhere should be subject to the same tax." S. Rep. No. 86-1393, at 24 (1960). The FTC statute "in effect treat[s] 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). As the Government acknowledged below, the FTC represents Congress' effort to "neutralize the effect of U.S. taxes on decisions where to invest or conduct business most productively." CA1 Govt. Br. 29. But the First Circuit's approach would frustrate Congress' decision to create parity between U.S. and foreign taxes so far as the U.S. income tax laws are concerned. Under the First Circuit's rule, the same transaction might be deemed "profitable" if conducted domestically, but "unprofitable" if undertaken on a cross-border basis, because in the latter situation foreign taxes would be treated as an "expense." This is the opposite of what Congress intended.

Uniform application of Congress' FTC scheme has important implications because the foreign tax credit "is the largest tax credit claimed by corporations," accounting for more than $100 billion

in tax credits annually. Luttrell, IRS Statistics of Income Bulletin, *Corporate Foreign Tax Credit, 2010*, at 1 (Fall 2014). Corporations across all economic sectors claimed foreign tax credits "tall[ying] 75.5 percent of all U.S. income tax before credits and 62.5 percent of U.S. income tax after credits." *Id.* at 2. The circuit splits at issue here thus undermines uniformity in one of the most significant areas of tax law.

As the briefs of numerous amici in the First Circuit explained, "[p]redictability and certainty are especially critical in the application of the FTC, whose core purpose is to encourage cross-border commerce. When companies consider cross-border investment and business activity, tax implications are a critical consideration." Br. of Amicus Curiae Financial Services Roundtable at 16, No. 16-1282 (1st Cir.); *see also* Br. of Amicus Curiae Chamber of Commerce of the United States at 1, 5-9, No. 16-1282 (1st Cir.) (explaining reliance of broad swath of business community on predictable application of FTC rules); Br. of Amicus Curiae Atlantic Legal Foundation at 32-33, No. 16-1282 (1st Cir.) (emphasizing taxpayers' need to minimize uncertainty in cross border transactions).

III. This Court's Prior Denial of Review In Nos. 15-380 and 15-572 Does Not Militate Against Review Here.

The Court has previously denied review in two related STARS cases: No. 15-380, *Salem Financial, Inc. v. United States* (Federal Circuit) (*cert. denied* Mar. 7, 2016), and No. 15-572, *Bank of New York Mellon Corp. v. Commissioner of Internal Revenue*

(Second Circuit) (*cert. denied* Mar. 7, 2016); *see also* No. 15-478, *American International Group v. United States* (presenting related issue from Second Circuit) (*cert. denied* Mar. 7, 2016).

These decisions should not dissuade the Court from granting review in this case. First, this case is a better vehicle than Nos. 15-380 and 15-572 because this petition presents the circuit split as part of the broader disagreement among the circuits as to the purpose and elements of judicial anti-abuse doctrines. The petitions in Nos. 15-380 and 15-572 addressed the application of the economic substance doctrine to foreign tax credits. Thus, the Question Presented in No. 15-572 began: "This petition concerns the application of the economic substance doctrine to foreign tax credits petitioner claimed for foreign taxes it paid on a multi-billion-dollar cross-border transaction." Pet. in No. 15-572, at i. The Question Presented in No. 15-380 similarly stated that "[t]his case involves the denial of a foreign tax credit for hundreds of millions of dollars in taxes." Pet. in No. 15-380, at i. The instant petition would allow the Court to address the broader principles discussed in the Sixth Circuit's recent decision in *Summa Holdings, Inc. v. Comm'r of Internal Revenue*, No. 16-1712, 2017 WL 631663 (6th Cir. Feb. 16, 2017), which makes clear that the circuit conflict is much more fundamental.

Next, the Government's arguments for denial of review in Nos. 15-380 and 15-572 have not withstood the test of time. In 2016, the Government told this Court that the Federal Circuit's decision in *Salem Financial* "lack[ed] prospective importance." BIO in

No. 15-380, at *12 (filed Jan. 4, 2016). But that forecast has been disproven. In this very case, the First Circuit followed the Federal Circuit's decision in *Salem Financial*.

Next, in 2016 the Government counseled this Court that review was unnecessary because the Federal Circuit's decision in *Salem Financial* did not depend on whether foreign taxes were treated as pre-tax expenses (the issue on which the Fifth and Eighth Circuit had ruled in *Compaq* and *IES*). According to the Government, the Federal Circuit in *Salem Financial* "did not rest its economic-substance determination on the fact that the STARS transaction was unprofitable after foreign taxes were paid." *Id.* at *14. Yet the First Circuit has now taken the opposite view of the Federal Circuit's decision in *Salem Financial*. The First Circuit explained – contrary to the Government's argument to this Court in 2016 – that the very basis of the economic substance determination is the fact that the STARS transaction was unprofitable after foreign taxes were paid. Pet. App. 16a-17a. In 2016, the Government told this Court that application of the economic substance test did not depend on the treatment of foreign taxes as expenses. In contrast, the First Circuit rested its decision on its determination that "the U.K. taxes . . . are factored into the pre-tax profitability calculation" under the economic substance test. *Id.*

Further, in 2016 the Government urged this Court to deny review in light of 2010 federal legislation providing that "tax benefits . . . with respect to a transaction are not allowable if the

transaction does not have economic substance or lacks a business purpose." 26 U.S.C. § 7701(o)(5)(A). *See* BIO in No. 15-380, at 18-19; BIO in No. 572, at 25-26. But nothing in the 2010 legislation resolves the circuit split at issue here regarding the purpose of the economic substance doctrine and its elements. The 2010 legislation codifies pre-existing "common law doctrine." *Id.* at § 7701(o)(5)(A). It prescribes that "[t]he 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." *Id.* § 7701(o)(5)(C). As directed by Congress, the IRS thus continues to apply pre-codification economic substance case law. *See* IRS Notice 2010-62, at 4 (Oct. 4, 2010) ("The IRS will continue to rely on relevant case law under the common-law economic substance doctrine in applying . . . section 7701(o)(1)."). Thus, the 2010 legislation does not obviate the need for this Court's review.

Indeed, if anything, the 2010 legislation *heightens* the need for this Court's review. With respect to the treatment of foreign tax payments in particular, Congress in 2010 rejected a House Ways and Means proposal to make foreign taxes an expense categorically, in assessing the economic substance of cross-border transactions.[8] In other

[8] The House Ways and Means Committee adopted a bill that would have expressly overruled *Compaq* and *IES*, stating that "foreign taxes shall be taken into account as expenses in determining pre-tax profit." H. Conf. Rept. No. 111-299 at 61 (2009) (proposed section 452(o)(2)(B)). But this language was omitted from the final statute, which instead

words, Congress rejected the rule adopted by the First Circuit in this case. Instead, Congress directed the Secretary of the Treasury to "issue regulations requiring foreign taxes to be treated as expenses in determining pre-tax profit *in appropriate cases*." 26 U.S.C. § 7701 (o)(2)(B) (emphasis added). Seven years later, Treasury has issued no such regulation, and courts continue to apply inconsistent rules. The First Circuit improperly stepped into the breach by adopting via judicial fiat a rule that Congress declined to enact and that the Treasury Department has declined to promulgate through notice-and-comment rulemaking.

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directed the Treasury to "issue regulations requiring foreign taxes to be treated as expenses in determining pre-tax profit in *appropriate cases*." 26 U.S.C. § 7701(o)(2)(B) (emphasis added). Notably, in its contemporaneous report on the enactment of Section 7701(o), the Joint Committee on Taxation cited *Compaq* and *IES* without suggesting that either was no longer good law. Staff of the J. Comm. on Tax'n, 111th Cong., 2d Sess., Technical Explanation of the Revenue Provisions of the "Reconciliation Act of 2010," as Amended, in Combination with the "Patient Protection and Affordable Care Act," 143 n.305, 145 n.312, 155 n.356 (JCX-18-10) (Comm. Print Mar. 21, 2010).

CONCLUSION

For the foregoing reasons, the petition for writ of certiorari should be granted.

Respectfully submitted,

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Dated: March 16, 2017

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Appendix A

United States Court of Appeals,
First Circuit.

Santander Holdings USA, Inc., and Subsidiaries, f/k/a Sovereign Bancorp., Inc., Plaintiff, Appellee,

v.

United States of America, Defendant, Appellant.

No. 16-1282
|
December 16, 2016

Before Lynch and Selya, Circuit Judges, and Burroughs,[*] District Judge.

Opinion

LYNCH, Circuit Judge.

Under the Internal Revenue Code, taxpayers receive, subject to various technical requirements, credits against owed U.S. income tax for every dollar paid to a foreign country for taxable international business transactions of economic substance. See 26 U.S.C. §§ 901–909. Over the past decade, some banks have engaged in complicated transactions the very purpose of which is to generate a foreign tax credit in order to take advantage of the U.S. deductions, and have done so at the expense of the U.S. taxpayer.

This case concerns whether Sovereign Bancorp, Inc., later acquired by Santander Holdings USA, Inc. (together, "Sovereign"), a U.S. taxpayer, is entitled to

a refund from the Internal Revenue Service ("IRS") after the IRS began disallowing its claim for foreign tax credits and imposing accuracy-related penalties in 2008. The credits at issue here were claimed for tax years 2003 to 2005 for taxes arranged to be paid to the United Kingdom as part of a Structured Trust Advantaged Repackaged Securities ("STARS") transaction that Sovereign had engaged in. This STARS transaction was initiated in 2003 and was scheduled to last five years, but it ended early, in July 2007, when STARS and similar transactions became the subject of heightened scrutiny from the IRS. See Determining the Amount of Taxes Paid for Purposes of Section 901, 72 Fed. Reg. 15,081 (proposed Mar. 30, 2007). Sovereign and Barclays Bank ("Barclays"), which is chartered in the United Kingdom, were the two parties to the transaction at issue.

Sovereign brought suit to obtain a refund from the IRS in the District of Massachusetts in 2009. The amount of the refund sought is approximately $234 million in taxes, penalties, and interest. Sovereign asserts that it is entitled to foreign tax credits against its U.S. taxes for taxes it paid to the United Kingdom as part of the STARS transaction at issue. As the government concedes, the STARS transaction complied on its face with then-existing U.S. statutory and regulatory requirements. But the government opposes the refund, arguing that the STARS transaction here is an "abusive tax shelter" and so amounts to a transaction that fails the common law economic substance test.

Congress and the IRS have long been concerned with taxpayers inappropriately seeking foreign tax credits.

IRS regulations proposed in 2007 and finalized in 2011 prohibited STARS transactions, but not retroactively. See Determining the Amount of Taxes Paid for Purposes of Section 901, 72 Fed. Reg. 15,081, 15,084 (proposed Mar. 30, 2007); Determining the Amount of Taxes Paid for Purposes of the Foreign Tax Credit, 76 Fed. Reg. 42,036 (July 18, 2011) (codified at 26 C.F.R. pt. 1). The regulations reflect an understanding that STARS transactions and similar complex financial structures for which foreign tax credits are sought both pose a danger to the federal fisc and do not serve the purposes intended by Congress in enacting the foreign tax credit regime. Those purposes include avoiding double taxation and enabling the conduct of business affairs abroad by U.S. firms. See H.R. Rep. No. 83–1337, at 4103 (1954) ("The [foreign tax credit] provision was originally designed to produce uniformity of tax burden among United States taxpayers, irrespective of whether they were engaged in business in the United States or engaged in business abroad."). This case involves a STARS transaction that took place before such transactions were forbidden by regulation, and no one contends the 2011 regulation applies. This decision thus directly affects only that transaction.

During roughly the same period as the transaction at issue here, from 2001 to 2007, other U.S. banks also entered into STARS transactions with Barclays. They similarly sought tax credits, and the IRS similarly opposed them. In Bank of New York Mellon Corp. v. Commissioner (BNY), 801 F.3d 104, 107 (2d Cir. 2015), the Second Circuit affirmed a judgment disallowing the credits claimed by Bank of New York

Mellon for its STARS transaction with Barclays.[1] Using somewhat different reasoning, the Federal Circuit in Salem Financial, Inc. v. United States, 786 F.3d 932, 951, 954–55 (Fed. Cir. 2015), also upheld a determination disallowing credits claimed by Branch Banking & Trust Corporation for a STARS transaction with Barclays. Both circuit court opinions contain extensive factual descriptions of the STARS transactions, which also largely characterize the transaction at issue here.[2] A third case, involving a Wells Fargo STARS transaction, was tried in a federal district court in the Eighth Circuit. See Wells Fargo & Co. v. United States, 143 F.Supp.3d 827, 842 (D. Minn. 2015). After trial, a jury found that the transaction lacked economic substance.

The Massachusetts district court in this case awarded summary judgment to Sovereign. It first entered

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[1] We note that while we discuss the findings of the Second Circuit in BNY, our opinion does not rely in any sense on the earlier opinion of the tax court in that case. See Bank of N.Y. Mellon Corp. v. Comm'r, 140 T.C. 15, as amended by 106 T.C.M. (CCH) 367 (T.C. 2013). Because we do not rely on that opinion, we need not address Sovereign's argument that the judge in that case suffered from a conflict of interest, a claim the government vigorously disputes.

[2] Although Sovereign argues on appeal that the transaction in BNY is distinguishable, it conceded below that the transaction was "very similar" to the one at issue here. And while Sovereign contends that the bank in Salem adopted a different litigation strategy than the one pursued by Sovereign, it does little to demonstrate that the STARS transaction in Salem involved any materially different facts.

partial summary judgment for Sovereign on the issue of whether a payment Sovereign received from Barclays should be considered income to Sovereign in calculating the STARS Trust transaction's profit. Santander Holdings USA, Inc. & Subsidiaries v. United States (Santander I), 977 F.Supp.2d 46, 48 (D. Mass 2013). It then entered judgment for Sovereign after finding as a matter of law that the Trust and Loan transactions had economic substance, and so Sovereign was entitled to interest-related deductions on expenses for the Loan transaction and a refund on the disallowed foreign tax credits claimed for the Trust transaction and the penalties imposed by the IRS. Santander Holdings USA, Inc. v. United States (Santander II), 144 F.Supp.3d 239, 248 (D. Mass. 2015). The court also denied the government's cross-motion for partial summary judgment in its favor on a number of issues, including whether Sovereign's U.K. taxes should be regarded as expenses in any calculation of Sovereign's profit from the STARS transaction. Id. at 242–44, 248. The government appeals from the grant of summary judgment to Sovereign and the denial of its cross-motion.

Through concessions made by both the government and Sovereign, the appeal has been considerably simplified. The government no longer contends that it is entitled to a jury trial on the tax refund claim; it seeks a jury trial only on the penalties claim. The government also does not contend any longer that the district court improperly excluded evidence, or that there are any material disputes of fact, or that summary judgment was entered prematurely. Rather, the government agrees that the controlling issue is one of law and argues that its cross-motion for

summary judgment as to the Trust portion of the STARS transaction should have been allowed.[3] Sovereign, for its part, agrees, for the purposes of summary judgment, that the proper focus is on the Trust transaction alone, and not on the Loan transaction.[4]

We hold that the district court committed reversible error and that the government is entitled to summary judgment in its favor as to the economic substance of the STARS Trust transaction. We largely agree with the reasoning of the Federal Circuit opinion in Salem in rejecting the claims that the Trust transaction had economic substance and substantially rely on its analysis.

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[3] The government also argued to the district court that the foreign tax credits claimed by Sovereign should be denied on the basis of two "substance over form" doctrines, the "step transaction" and "conduit" doctrines, but the district court rejected the argument. Santander II, 144 F.Supp.3d at 244. As the government focuses its appeal on the economic substance doctrine, we do not consider the district court's rejection of the government's substance-over-form argument.

[4] The parties have agreed for purposes of this appeal that the Trust transaction should be analyzed separately from the Loan transaction. The bank in Salem similarly accepted the bifurcation of the tax consequences of the Trust transaction and the Loan transaction for purposes of that appeal. Salem, 786 F.3d at 940. The government no longer contests the economic substance of the Loan transaction, as long as the Loan transaction is analyzed separately from the Trust transaction, and does not appeal the district court's decision that Sovereign may claim certain interest-expense deductions.

I.

We give a brief description of the transaction and then of this Circuit's economic substance test.

A. The STARS Transaction

Sovereign entered into the STARS transaction with Barclays in 2003. U.S. banks were then aware of the tax risks of being denied the full amount of U.S. foreign tax credits. See, e.g., Salem, 786 F.3d at 937. Like other STARS transactions, the one Sovereign entered into had, as the district court put it, a "Rube Goldberg" complexity. Santander I, 977 F.Supp.2d at 48. We explain it briefly and rely on BNY and Salem for further details.

In 2003, Sovereign first created a Trust (the Trust half of the transaction) into which it ultimately contributed about $6.7 billion of its U.S.-located income-producing assets. The trustee of the Trust was, by its terms, a U.K. citizen, a fact which subjected the Trust to U.K. taxes. The U.K. taxes were at a rate of 22%. The Trust was also subject to U.S. federal income tax at a rate of 35%, but it could claim a tax credit for the taxes paid to the United Kingdom. The Trust was structured, therefore, to receive foreign tax credits for the amount paid in tax on the Trust to the United Kingdom. It is undisputed that Sovereign paid all U.K. taxes for which it claimed U.S. tax credits.

Barclays acquired an interest in the Trust for $750 million in November 2003 at the Trust's initial creation and acquired an additional $400 million interest almost a year later, when Sovereign added

additional funds to the Trust. Significantly, Barclays was required to sell its interest in the Trust back to Sovereign for $1.15 billion at the end of the transaction.

Sovereign treated this $1.15 billion contribution from Barclays as a Loan (the Loan half of the STARS transaction) for accounting and regulatory purposes, including in all of Sovereign's filings to the Securities and Exchange Commission and the Office of Thrift Supervision. The offsetting agreements that converted Barclays's purchase of an interest in the Trust into the Loan effectively resulted in Barclays lending Sovereign $750 million at a floating monthly rate of LIBOR[5] plus 50 basis points and $400 million at LIBOR plus 25 basis points.[6]

The Trust engaged in a series of actions that generated a U.K. tax benefit for Barclays. The Trust

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[5] LIBOR stands for "Intercontinental Exchange London Interbank Offered Rate." Salem, 786 F.3d at 937 n.1. LIBOR "is a benchmark rate that some of the world's leading banks charge each other for short-term loans." Id.

[6] When it first marketed this transaction to potential counterparties, Barclays did not include this Loan component. See Salem, 786 F.3d at 936. The government suggests that Barclays added the Loan to "disguise the true nature of the [transaction] and permit U.S. taxpayers to justify STARS as low-cost funding." Sovereign asserts that "there is no evidence ... that any non-loan transaction was ever offered to (or considered by) Sovereign," and that "[t]o the extent Barclays may have proposed a non-loan transaction to other banks, the evidence shows they were uninterested in it." Because we must analyze the Loan and Trust transactions separately, this dispute is immaterial.

distributed funds to a Barclays Blocked Account, which Barclays could not access, but which allowed Barclays to formally hold the funds in its name. The Barclays Blocked Account then immediately returned the funds to the Trust. Barclays owed U.K. taxes on the distributions made to the Barclays Blocked Account, but, importantly, Barclays was entitled to a tax credit for the U.K. tax paid on this income by the Trust, and Barclays also was permitted to deduct its re-contributions to the Trust as a tax loss. The combination of the tax credit and deduction "creat[ed] a net tax deduction for Barclays that it could use to offset tax on other income unrelated to [the STARS transaction]."

In exchange, Barclays paid Sovereign a monthly sum, referred to as the "Barclays" or "Bx" payment. The amount of the Bx payment was calculated to equal 50% of the U.K. tax Sovereign paid on the Trust's income. In a sense, the 50% was a return to Sovereign of half of its tax payment, whether or not it was technically a rebate. The Bx payment was "netted against Sovereign's interest obligation" on the Loan.

The benefits for both parties can be illustrated by a hypothetical also employed by the Second and Federal Circuits. See BNY, 801 F.3d at 111; Salem, 786 F.3d at 938. Assume $100 of income in the Trust for a given month. Through its ownership interest in the Trust and the Trust's structure, Barclays would be liable for a 30% U.K. corporate tax on the Trust's income, amounting to $30. BNY, 801 F.3d at 111. Barclays would then claim a credit for the 22% U.K. tax paid on the Trust by Sovereign amounting to $22, bringing Barclays's own tax liability down to $8. Id. The Trust

would set aside $22 to settle the U.K. tax owed by Sovereign; the remaining $78 would be shuttled into and out of the Barclays Blocked Account. Id. Sovereign would claim a U.S. foreign tax credit for the $22 it paid in U.K. taxes. Id.

Upon redistributing the $78 to the Trust from the Barclays Blocked Account, Barclays would claim a trading loss deduction on the $78 which, at the corporate tax rate of 30%, would amount to $23.40. Id. Barclays would make a Bx payment to Sovereign calculated to be half of the 22% U.K. tax paid by Sovereign, which would amount to $11. Id. Barclays then deducted this payment at the 30% U.K. tax rate as well, resulting in a $3.30 deduction. Id. In the end, Barclays would save $7.70 in taxes for each $100 of Trust income ($23.40 – $8 – $11 + $3.30), and Sovereign would save $11 (the amount of the Bx payment calculated against Sovereign's U.K. tax exposure). Id. Both parties ultimately reduced their tax exposure—Barclays through the various deductions generated by the Trust transaction and Sovereign through the Bx payment.

B. The Economic Substance Doctrine

The federal income tax is, and always has been, based on statute. The economic substance doctrine,[7] like

[7] Sovereign argues that the foreign tax credit area is so heavily populated with IRS regulation that there is no need for any further regulation by the courts under the guise of the economic substance doctrine. On these facts, we reject the proposition. In practical terms, it takes time for the government to analyze a new problem, come up with a solution, and promulgate regulations. "The endless ingenuity of taxpayers in attempting to avoid taxes means

other common law tax doctrines, can thus perhaps best be thought of as a tool of statutory interpretation,[8] as then-Judge Breyer characterized it in his opinion for this court in Dewees v. Commissioner, 870 F.2d 21, 35–36 (1st Cir. 1989).

The common law economic substance doctrine traces back to the Supreme Court's decision in Gregory v. Helvering, 293 U.S. 465, 55 S.Ct. 266, 79 L.Ed. 596 (1935).[9] The Court there looked beyond the fact that a corporate reorganization technically complied with the statutory requirement and found that it lacked

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that there will be a first time for everything," Wells Fargo, 143 F.Supp.3d at 838, and the economic substance test guards against abuse of loopholes that Congress and the IRS have not anticipated.

[8] As one commentator says:

> A related ... claim is that the legislature assumes that long-standing common law doctrines such as economic substance will be used to interpret the statutes it enacts. Under this claim, the doctrines have been implicitly adopted as part of the statute—at least where the statute does not indicate otherwise.

Joseph Bankman, The Economic Substance Doctrine, 74 S. Cal. L. Rev. 5, 11 (2000)

[9] In 2010, Congress enacted a statutory economic substance test. See 26 U.S.C. § 7701(o). The statutory test was not made retroactive. Our analysis, however, is not in conflict with that test, as Congress specified that the 2010 codification would be applied as courts have previously and consistently applied the economic substance doctrine. Id. § 7701(o)(5)(C). If the codification reveals anything about congressional intent as to pre–2010 STARS transactions, it supports our conclusion.

economic substance. Id. at 468–70, 55 S.Ct. 266. It found as such because the reorganization was:

> an operation having no business or corporate purpose—a mere device which put on the form of a corporate reorganization as a disguise for concealing its real character, and the sole object and accomplishment of which was the consummation of a preconceived plan, not to reorganize a business or any part of a business, but to transfer a parcel of corporate shares to the petitioner.

Id. at 469, 55 S.Ct. 266. The Court reached this conclusion from the fact that "the transaction upon its face lies outside the plain intent of the statute." Id. at 470, 55 S.Ct. 266.

The Court clarified the doctrine further in Frank Lyon Co. v. United States, 435 U.S. 561, 98 S.Ct. 1291, 55 L.Ed.2d 550 (1978), where it reversed the Eighth Circuit's decision that a sale-and-leaseback transaction did not meet the economic substance test. Id. at 584, 98 S.Ct. 1291. The Court explained that "[i]n applying this doctrine of substance over form, the Court has looked to the objective economic realities of a transaction rather than to the particular form the parties employed." Id. at 573, 98 S.Ct. 1291 (emphasis added).

The First Circuit has addressed challenges to the economic substance of transactions in a number of cases, although the cases often have not invoked the

"economic substance doctrine" by that name. See, e.g., Stone v. Comm'r, 360 F.2d 737 (1st Cir. 1966); Fabreeka Prods. Co. v. Comm'r, 294 F.2d 876 (1st Cir. 1961); Granite Tr. Co. v. United States, 238 F.2d 670 (1st Cir. 1956). This court has been particularly wary of inquiring into the subjective motivations of taxpayers: "[U]nless Congress makes it abundantly clear, we do not think tax consequences should be dependent upon the discovery of a purpose, or a state of mind, whether it be elaborate or simple." Fabreeka Prods. Co., 294 F.2d at 878.

Dewees is our most recent significant case on the economic substance doctrine. There, this court upheld a tax court decision that a "loss [the petitioners] incurred while engaged in 'straddle' trading on the London Metals Exchange was not an 'ordinary loss' deductible from their income." Dewees, 870 F.2d at 22. The tax court held that the loss was not deductible because the straddle trades were sham transactions and not "entered into for profit" within the meaning of section 108 of the Internal Revenue Code. Id.

This court upheld the tax court's decision for four principal reasons. We emphasized that the case was one of some 1,100 consolidated by the tax court, from the general pattern of which the tax court could infer that the transactions were designed to avoid taxes; that the promotional material for the transactions focused exclusively on their tax effects; that although margin accounts were opened for the transactions, none of the investors in any of the transactions ever received a margin call; and that no investor ever made a net profit or "was ever asked to pay a loss, beyond

the initial margin deposit" for the transactions.[10] Id. at 31. We rejected the petitioner's argument that we must analyze the taxpayer's subjective motivation under the relevant statutory framework. Id. at 34. Among other reasons, the court noted that the tax court had concluded that the transactions were "shams in substance," and that "[c]ase law makes clear that a taxpayer cannot deduct a 'sham transaction' loss, irrespective of his subjective profit motive." Id. at 35.

Dewees instructs that the economic substance doctrine is centered on discerning whether the challenged transaction objectively "lies outside the plain intent of the [relevant statutory regime]." Id. at 29 (quoting Gregory, 293 U.S. at 470, 55 S.Ct. 266). It further instructs that a transaction fails the economic substance test if, "though [it] actually occurred and technically complied with the tax code, [it] w[as] mere[ly a] device[ ] to avoid tax liability." Id. at 30; see also Schussel v. Werfel, 758 F.3d 82, 97 (1st Cir. 2014) (noting that courts may "disregard the form of transactions that have no business purpose or

[10] To the extent that similar evidence is in the record for this case, it supports our conclusion. As in Dewees, we have examined the pattern that has emerged from comparable STARS transactions. We have used Sovereign's and Barclays's communications to each other about the transaction and, in particular, their emphasis on the connection of the Bx payment to Sovereign's U.K. taxes and the Trust transaction's "tax risk," to conclude that the Trust transaction had no objective purpose outside its tax effect. And we too have noted that the transaction at issue here was structured such that it exposed neither party to realistic non-tax risk.

economic substance beyond tax evasion"). In other words, when a transaction "is one designed to produce tax gains ... [not] real gains," Dewees, 870 F.2d at 31—such as when the challenged transaction has no prospect for pre-tax profit—then it is an act of tax evasion that, even if technically compliant, lies outside of the intent of the Tax Code and so lacks economic substance.

II.

"We review orders granting or denying summary judgment de novo." Fithian v. Reed, 204 F.3d 306, 308 (1st Cir. 2000). "The general characterization of a transaction for tax purposes is a question of law subject to review." Frank Lyon, 435 U.S. at 581 n.16, 98 S.Ct. 1291.

In its first partial summary judgment decision, the district court rejected the government's argument that the Bx payment was in effect a tax rebate. Santander I, 977 F.Supp.2d at 50. The district court concluded instead that the Bx payment as a matter of law was income to Sovereign. Id. at 52. The Federal Circuit reached the same conclusion as the district court in our case and held that the Bx payment must be counted as income under the logic of Old Colony Trust Co. v. Commissioner, 279 U.S. 716, 49 S.Ct. 499, 73 L.Ed. 918 (1929); IES Industries, Inc. v. United States, 253 F.3d 350 (8th Cir. 2001); and Compaq Computer Corp. & Subsidiaries v. Commissioner, 277 F.3d 778 (5th Cir. 2001). Salem, 786 F.3d at 944–46. By contrast, the Second Circuit accepted the government's argument. BNY, 801 F.3d at 121–22.

We see no need to address the government's characterization of the Bx payment as a rebate, not income, because we hold that whether the Bx payment is best characterized as a rebate or as income, Sovereign's argument still fails. The STARS Trust transaction itself does not have a reasonable prospect of creating a profit without considering the foreign tax credits, and, as a result, it is not a transaction for which Congress intended to give the benefit of the foreign tax credit. This conclusion mirrors that of the Federal Circuit in Salem, and we reach it largely for the reasons stated there. Salem, 786 F.3d at 946–55. We agree with that court that we must "assess [the] transaction's economic reality, and in particular its profit potential, independent of the expected tax benefits." Id. at 948. Using similar reasoning, we find that the Trust transaction is "shaped solely by tax-avoidance features," id. at 942 (quoting Stobie Creek Invs. LLC v. United States, 608 F.3d 1366, 1375 (Fed. Cir. 2010)), that "lack a bona fide business purpose," id. Most importantly, we agree with the Federal Circuit that the Trust transaction is profitless, id. at 949, and that it is "not the type of transaction Congress intended to promote with the foreign tax credit system," id. at 954.

The Trust transaction is profitless because the "profit" to Sovereign from the Bx payment comes at the expense of exposure to double the Bx payment's value in U.K. taxes. To return briefly to the $100 hypothetical: even if Sovereign receives an $11 Bx payment from Barclays (half of the $22 paid by Sovereign to the United Kingdom at its 22% tax rate), the Trust transaction lacks a reasonable potential (or any potential) of generating profit because the $11 Bx

payment is earned at the expense of the $22 U.K. tax. In other words, every $1 the Trust transaction earns through the Bx payment costs $2 from the transaction costs of subjecting the Trust transaction to U.K. tax. When the primary transaction cost of the Bx payment, the U.K. taxes, are factored into the pre-tax profitability calculation, the Trust transaction is plainly profitless.[11] Sovereign's "profit" comes from the foreign tax credits it claims for the U.K. taxes combined with a Bx payment calculated as half its U.K. tax liability.

Accordingly, we conclude both that the STARS Trust transaction had no objective non-tax economic benefit and that Congress, in creating the foreign tax credit

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[11] Because exposure to U.K. taxation was the necessary and sufficient condition of the Bx payment, the U.K. taxes were an expense incurred by Sovereign for the "profit" generated by the Trust transaction. And when the U.K. taxes are recognized as expenses, there is no pre-tax profit, and the Trust transaction lacks a cardinal feature of an economically substantial transaction: a reasonable prospect of pre-tax profit. Sovereign and the district court rely heavily on Compaq and IES for the proposition that foreign taxes should not be treated as expenses. Santander II, 144 F.Supp.3d at 242–44. Those cases did not analyze STARS transactions and so are distinguishable factually. We agree with the Salem court's analysis of this issue as to the Trust transaction. 786 F.3d at 947–49.

Nor does our conclusion that Sovereign's U.K. taxes should be considered expenses contradict the Supreme Court's holding in Old Colony. Old Colony did not involve foreign taxes and says nothing about whether foreign tax liability may ever be considered an expense. See Old Colony, 279 U.S. at 716, 49 S.Ct. 499.

regime, did not intend that it would cover this type of generated transaction.[12] Exposure to U.K. taxation for the purpose of generating U.S. foreign tax credits was the Trust transaction's whole function.

Our conclusion that the Trust transaction lacks economic substance is entirely consistent with our statement in Dewees that "taxpayers may lawfully structure transactions that seek real gains in a way that also maximizes tax advantages." 870 F.2d at 32. Again, this situation does not involve private parties structuring an agreement to benefit both parties and only then seeking to maximize the tax benefits. The Bx payments do not come into fruition until and unless Sovereign pays the U.K. taxes (for which it will seek a 100% credit on its U.S. taxes).

Indeed, the record demonstrates that the Bx payment is inextricably linked to the deliberate incurring of Sovereign's U.K. tax liability. Barclays and Sovereign made clear to each other that the Bx payment would be calculated based on Sovereign's U.K. tax liability

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[12] See John P. Steines, Jr., Subsidized Foreign Tax Credits and the Economic Substance Doctrine, 70 Tax Lawyer (forthcoming 2017) ("[I]t is virtually impossible for a dispassionate analyst to reasonably conclude that Congress intended to surrender more revenue than that captured by the foreign government in a holistic sense where the U.S. taxpayer and the counterparty split the remaining spoils solely by reason of carefully exploited inconsistent international tax rules in an otherwise unprofitable transaction that is an overly complicated version of an orthodox deal that would not have given rise to credits at all."). A copy of this article was filed with the court and disclosed to the parties.

and the credits that Barclays would then be able to claim. An internal communication between the parties stated that the Bx payment would allow "Barclays [to] share[ ] U.K. tax credits with Sovereign."

The STARS scheme is profitable only because Sovereign plans to obtain U.S. tax credits; that is, the whole existence of the Trust transaction depends on getting a U.S. tax credit. There is otherwise no business reason to engage in the transaction. As the Salem court found:

> The evidence thus supports the trial court's finding that the STARS Trust was a "prepackaged strategy" created to generate U.S. and U.K. tax benefits for [the counterparty] and Barclays. Barclays agreed to bear half of [the counterparty's] U.K. tax expense under the transaction in exchange for an opportunity to claim substantial U.K. tax benefits for itself (through the trading loss deduction). [The counterparty], on the other hand, benefited by claiming a foreign tax credit equal to the entire amount of the Trust's U.K. taxes while "getting back one-half of the U.K. tax" from Barclays. Absent those tax advantages, the STARS transaction would never have occurred.

786 F.3d at 952 (citation omitted). Here, Sovereign subjected its property and income to U.K. taxation

only because it anticipated it could avoid U.S. taxes through the resulting U.S. tax credit.

The Trust transaction did not advance the Tax Code's interest in providing foreign tax credits in order to encourage business abroad or in avoiding double taxation. Nor does disallowing foreign tax credits for the STARS Trust transaction interfere with the United Kingdom's authority. After all, it was the U.K. authorities who in 2005 first called STARS transactions to the attention of the IRS as a potential impermissible tax shelter.[13]

Of course, as the government readily admits, some transactions that are not immediately profitable

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[13] Moreover, there is no tension between denying foreign tax credits for the STARS Trust transaction and the U.S.–U.K. tax treaty: As the government correctly notes, the treaty requires the grant of foreign tax credits "subject to the limitations of the laws of the United States." Convention with Great Britain and Northern Ireland regarding Double Taxation and Prevention of Fiscal Evasion, art. 24, July 24, 2001, S. Treaty Doc. No. 107–19. Among those limitations, of course, are "anti-abuse principles" such as the economic substance doctrine. See Treasury Dep't, Technical Explanation of the Convention Between the Government of the United States of America and the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital Gains 14. See also Del Commercial Props., Inc. v. Comm'r, 251 F.3d 210, 214 (D.C. Cir. 2001) ("[I]f the sole purpose of a transaction with a foreign corporation is to dodge U.S. taxes, [a] treaty cannot shield the taxpayer from the fatality of the [substance-over-form] step-transaction doctrine.").

without tax benefits, such as investments in "nascent technologies," may have economic substance. See Salem, 786 F.3d at 950. But the Trust transaction is not comparable to such transactions because it does not "meaningfully alter[ ] the taxpayer's economic position (other than with regard to the tax consequences)." Id.

Moreover, unlike long-term investments that may not initially turn a profit, but which have economic substance, the Trust transaction lacks any real economic risk. The Salem court pointed out that Barclays ran little risk of having to pay the Bx payment in absence of the anticipated U.K. tax benefits because the counterparty indemnified Barclays should that happen. Id. at 943–44. The Bx payments were not truly independent of the expected U.K. tax effects. The counterparty's "ability to benefit economically from the Bx payments depended on Barclays'[s] receipt of its expected tax benefits, which in turn depended on the Trust's U.K. tax payments." Id. at 944.

Here, too, Sovereign and Barclays "developed contractual remedies and took other steps to minimize the risk of [a divergence between actual effects and the pre-engineered outcome of the Bx payment's relationship to the U.K. taxes]." Unlike transactions that have survived an economic substance challenge, such as the sale-and-leaseback structure in Frank Lyon, 435 U.S. at 577, 98 S.Ct. 1291, the STARS Trust transaction posed no non-tax risks to Sovereign. Instead, Sovereign's internal discussions focused on the "risk" of being unable to claim foreign tax credits for the U.K. taxes on the

Trust transaction, and it informed the Federal Deposit Insurance Corporation that it would "bear the United States tax risk" of the transaction.

Further, we agree with the government that Sovereign's U.K. tax was artificially generated through a series of circular cash flows through the Trust and was the quid pro quo for the Bx payment. The assets in the Trust never effectively left Sovereign's control, nor did they perform any function when placed in the Trust that they could not without the Trust—other than, of course, creating the tax effect that made possible the Bx payment. Indeed, when calculating the profit potential of the STARS transaction, Sovereign deducted the income from the Trust assets, as that income would have been earned without the Trust's existence.

Resorting to the uncontroversial principle that the foreign tax credit regime was designed to avoid double taxation does not help Sovereign. If mere invocation of that principle were enough, every tax avoidance scheme would pass muster. After all:

> the fact that the transactions produced a net gain to the taxpayer after taking both the foreign taxes and the foreign tax credit into account says nothing about the economic reality of the transactions, because all tax shelter transactions produce a gain for the taxpayer after the tax effects are taken into account—that is why taxpayers are willing to enter into them and to pay substantial fees to the promoters.

Salem, 786 F.3d at 948.

Equally fundamental to the purpose of granting foreign tax credits is the related principle that those credits are extended only to legitimate business transactions. See H.R. Rep. No. 83–1337, at 4103 (1954) ("The [foreign tax credit] provision was originally designed to produce uniformity of tax burden among United States taxpayers, irrespective of whether they were engaged in business in the United States or engaged in business abroad." (emphasis added)). The Trust transaction provided no business for Sovereign. It furnished Barclays with a tax benefit, which Barclays in turn shared with Sovereign, effectively giving Sovereign a tax benefit of its own when combined with the anticipated foreign tax credits. The Trust transaction was not a legitimate business and lacked economic substance.

III.

We reverse the judgment of the district court as to the economic substance of the Trust transaction and the foreign tax credits claimed for the Trust transaction and remand for judgment to be entered for the United States on the refund claim and for a trial limited to the penalties issue. Costs are awarded to the appellant.

Appendix B

United States District Court,
D. Massachusetts.

SANTANDER HOLDINGS USA, INC. &
SUBSIDIARIES, Plaintiff,

v.

UNITED STATES of America, Defendant.

Civil Action No. 09–11043–GAO.

Oct. 17, 2013.

OPINION

O'TOOLE, District Judge.

Santander Holdings USA, Inc., formerly known as Sovereign Bancorp, Inc., and referred to in this opinion as "Sovereign," has sued to recover approximately $234 million in federal income taxes, penalties, and interest that it claims were improperly assessed and collected by the Internal Revenue Service for tax years 2003, 2004, and 2005 as a consequence of the IRS's disallowance of foreign tax credits claimed by Sovereign for those years. The United States defends the disallowance on the ground that the transaction in which Sovereign incurred and paid the foreign taxes against which the credit was taken was a "sham" conducted not for its real economic value but rather as a contrived means of generating the tax benefit provided by the foreign tax credit.

Sovereign recently moved for partial summary judgment on a linchpin issue: whether a payment Sovereign received in the transaction from its counterparty, Barclays Bank PLC ("Barclays"), should be accounted for as revenue to Sovereign in assessing whether Sovereign had a reasonable prospect of profit in the transaction. It is the government's position that the payment should be excluded from a calculation of Sovereign's pre-tax profit as a "tax effect" because the payment is an "effective rebate" of U.K. taxes paid by Sovereign. If the payment is excluded, as the government contends it should be, then the transaction at issue does not show a reasonable prospect of profit, but if it is included, as Sovereign contends, it shows a substantial profit to Sovereign from the transaction. This basic binary fact is not genuinely disputed. The existence or not of a reasonable prospect of profit is critical in determining whether the transaction had objective economic substance for purposes of assessing whether it was a "sham" or not. If the payment is counted as pre-tax revenue, it is objectively clear that the transaction has economic substance for Sovereign.

The parties submitted voluminous briefing on the matter and were heard in extended oral argument. At a pretrial conference on September 25, 2013, I announced from the bench that Sovereign's motion for partial summary was being granted. I gave a brief oral statement of my reasoning, promising a more detailed written opinion to come. This is that opinion, and it supersedes the brief oral statement of reasons.

I. The STARS Transaction

Barclays is chartered by the United Kingdom. Together with its adviser, KPMG, Barclays developed and proposed to several U.S. banks, including Sovereign, a "Structured Trust Advantaged Repackaged Securities" ("STARS") transaction. Viewed from 30,000 feet, the STARS transaction was designed to give Barclays substantial benefits under U.K. tax laws, in light of which Barclays could and would offer to lend funds to U.S. banks at a lower cost than otherwise might be available to them. The banks could relend the money in their normal banking operations, using the lower cost either to obtain a competitive advantage or to increase their marginal return on lending or both. Up close, however, the transaction was surpassingly complex and unintuitive; the sort of thing that would have emerged if Rube Goldberg had been a tax accountant. The government might be forgiven for suspecting that the designers of anything this complex must be up to no good, but that understandable instinctive reaction is not a substitute for careful analysis, and on careful analysis, the government's position does not hold up.

A very brief overview of the transaction is sufficient for present purposes. Sovereign created a trust to which it contributed $6.7 billion of income generating assets. The trustee of the trust was purposely made a U.K. resident, causing the trust's income to be subject to U.K. income taxation at a rate of 22 percent. The trust income was also subject to U.S. income taxation and was attributed to Sovereign, but with a credit available for the amount paid in U.K. income taxes under section 901 of the Internal Revenue Code ("the Code"). 26 U.S.C. § 901. Sovereign paid U.K. taxes

and then claimed credits for the amounts paid in calculating its U.S. income tax liability for the tax years in question.

The transaction included a number of contrived structures and steps that, each viewed in isolation, would make little or no sense. For example, Barclays had an ownership interest in the trust and as a result received monthly distributions from the trust, which, under the terms of the transaction, it was required immediately to re-contribute to the trust. Standing in isolation, this circular movement of distributions would make no sense. In the context of the entire transaction, however, it was crucial to Barclays' obtaining favorable tax treatment under U.K. law, which gave it the ability to lower its effective lending rate to a U.S. bank. The result of the STARS transaction for Barclays was a net tax *gain,* which it was able to use to reduce other U.K. tax liabilities that it owed.[1]

The loan aspect of the transaction was also highly structured in an idiosyncratic way, although it was consistently treated by Sovereign for accounting and regulatory purposes as a secured loan, acceptably to regulating agencies, including the Securities and Exchange Commission and the Office of Thrift Supervision. One feature of the loan arrangements was what was denominated the "b_x payment," or the

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[1] Whether Barclays' maneuvers abused any U.K. tax laws is not an issue here. In any event, it appears from the record that the U.K. tax authorities were well aware of the STARS transaction and made no objection.

"Barclays payment."[2] It was calculated as approximately one-half of the amount Sovereign paid in taxes to the U.K. on the income earned by the trust. While in the intricacies of the transaction it was actually a monthly credit to Sovereign figured into its interest costs, the government refers to it as an affirmative payment in support of its "effective rebate" argument, and Sovereign accepts that characterization for purposes of this motion.[3]

II. Discussion

There is no dispute that for the years in question Sovereign incurred and paid U.K. taxes on the trust income, also reported the income on its U.S. tax returns, but claimed a foreign tax credit for the amount it paid to the U.K. There is no claim by the government that the foreign tax credit was improperly calculated or that Sovereign failed to comply with any applicable provision of statute or regulation relative to it. Rather, the government's position is that Sovereign did not *in substance* pay the U.K. taxes claimed because the Barclays payment was an "effective rebate" of one-half of Sovereign's U.K. taxes. In other words, the Barclays payment

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[2] The term "b_x" comes from the elaborate formulae used by the parties to the transaction to calculate various values. (*See, e.g.,* Pl.'s Mem. in Supp. of Mot. for Partial Summ. J., Ex. 7 (dkt. no. 125–7) ("Amended and Restated Formulae Letter,").)

[3] Sovereign also accepts, for purposes of the motion only, that the STARS transaction can be bifurcated into trust and loan transactions, so that the trust transaction can be evaluated without including the loan transaction. Its broader view in the litigation is that the trust and loan components must be evaluated together.

effectively relieved Sovereign of half the burden of its U.K. taxes.

In order to challenge what would otherwise be a valid claim of a foreign tax credit, the government reaches for its trump card—the "economic substance" doctrine. *Cf. In re CM Holdings, Inc.,* 301 F.3d 96, 102 (3d Cir.2002) (referring to the economic substance doctrine as the government's "trump card"). Literal compliance with the letter of the Code and regulations may be disregarded if it appears that the transaction in question had no economic substance but was simply a tax-avoiding contrivance. *Gregory v. Helvering,* 293 U.S. 465, 470, 55 S.Ct. 266, 79 L.Ed. 596 (1935). The same principle has been articulated variantly as the "substance over form" doctrine, *see Frank Lyon Co. v. United States,* 435 U.S. 561, 573, 98 S.Ct. 1291, 55 L.Ed.2d 550 (1978), the "sham transaction" doctrine, *see IES Indus., Inc. v. United States,* 253 F.3d 350, 353 (8th Cir.2001), and even the "sham in substance" doctrine, *see Dewees v. C.I.R.,* 870 F.2d 21, 29 (1st Cir.1989). The principle is the same regardless of the label: if a transaction has no legitimate, non-tax business purpose and thus, apart from expected tax benefits, has no genuine economic substance, it may be disregarded for purposes of assessing taxes. *See CM Holdings,* 301 F.3d at 103 ("The main question these different formulations address is a simple one: absent the tax benefits, whether the transaction affected the taxpayer's financial position in any way."). A transaction will be found to have economic substance if it had "a reasonable possibility of a profit." *Fid. Int'l Currency Advisor A Fund, LLC, by Tax Matters Partner v. United States,* 747 F.Supp.2d 49, 231 (D.Mass.2010),

aff'd sub nom. Fid. Int'l Currency Advisor A Fund, LLC ex rel. Tax Matters Partner v. United States, 661 F.3d 667 (1st Cir.2011).

The government says the Barclays payment was not "in substance" a payment by Barclays at all, but rather it was "effectively" a rebate of taxes originating from the U.K. tax authorities. The theory is that Barclays was only able to make the payment because of the tax credits *it* had received from the U.K.

The argument is wholly unconvincing. In the first place, the Code and regulations contain explicit provisions addressing when a foreign tax may be considered rebated by the taxing authority and when a taxpayer may be considered to have received a subsidy (a rebate is a type of subsidy) from a foreign source to pay its foreign taxes. Under the Code,

> Any income, war profits, or excess profits tax shall not be treated as a tax for purposes of this title to the extent— **(1)** the amount of such tax is used (directly or indirectly) by the country imposing such tax to provide a subsidy by any means to the taxpayer, a related person (within the meaning of section 482), or any party to the transaction or to a related transaction, and **(2)** such subsidy is determined (directly or indirectly) by reference to the amount of such tax, or the base used to compute the amount of such tax.

26 U.S.C. § 901(i)(1)-(2). Treasury Regulations provide:

> An amount is not tax paid to a foreign country to the extent that it is reasonably certain that the amount will be refunded, credited, rebated, abated, or forgiven. It is not reasonably certain that an amount will be refunded, credited, rebated, abated, or forgiven if the amount is not greater than a reasonable approximation of final tax liability to the foreign country.

26 C.F.R. § 1.901–2(e)(2). Further,

> **(i) General rule.** An amount of foreign income tax is not an amount of income tax paid or accrued by a taxpayer to a foreign country to the extent that—(A) The amount is used, directly or indirectly, by the foreign country imposing the tax to provide a subsidy by any means (including, but not limited to, a rebate, a refund, a credit, a deduction, a payment, a discharge of an obligation, or any other method) to the taxpayer, to a related person ..., to any party to the transaction, or to any party to a related transaction; and
>
> (B) The subsidy is determined, directly or indirectly, by reference to the amount of the tax or by reference to the base used to compute the amount of the tax.
>
> **(ii) Subsidy.** The term "subsidy" includes any benefit conferred, directly or indirectly, by a foreign country to one

> of the parties enumerated in paragraph (e)(3)(i)(A) of this section. *Substance and not form shall govern in determining whether a subsidy exists.* The fact that the U.S. taxpayer may derive no demonstrable benefit from the subsidy is irrelevant in determining whether a subsidy exists.

26 C.F.R. § 1.901–2(e)(3) (emphasis added). In pretrial discovery, the government abjured any claim that the Barclays payment was a subsidy under these provisions. (*See* Pl.'s Mem. in Supp. of Mot. for Partial Summ. J., Ex. 4 at 16 (dkt. no. 125–4) ("Response to Interrogatory No. 41").) As the emphasized sentence indicates, that concession must be understood to mean that the Barclays payment was not "in substance" a subsidy.

Nevertheless, the government presses its argument that the Barclays payment was "in substance" a rebate from the U.K. But the government can point to no governing or precedential legal authority that supports treating the private payment between Barclays and Sovereign as a payment from the U.K. treasury, because there is none. It has some decisions at the first-instance level that have generally accepted its theory about the STARS transaction, but as this opinion explains, I find those decisions unpersuasive.

Lacking compelling legal authority, the government proffers the learned opinions of its putative expert witnesses. The problem is that their opinions do not matter, because the necessary question is not a

question of fact—What happened?—but rather a question of law—How should what happened be classified for purposes of applying the law? That is why this issue is amenable to resolution on a motion for summary judgment. The facts of the transaction are not in dispute. There is no material factual issue about how the credits and debits worked their labyrinthine way through the Goldbergian apparatus. The question is, Should the Barclays payment be treated, as a matter of law, as if it were a rebate from the U.K. to Sovereign? That is a legal question, to be answered by judges, not economists. *See IES,* 253 F.3d at 351 ("The material facts are undisputed; the question of law before us is the general characterization of a transaction for tax purposes.").

The Barclays payment was certainly not an *actual* rebate by the U.K.[4] Nor is there any reason to treat it as an "effective" or constructive rebate. There is no authority to do so. On the contrary, the terms "taxes" and "tax credits" are properly understood to refer to transactions between a taxpayer and a taxing authority, not transactions between private parties, even if the "effect" is to lessen for a taxpayer the economic burden of having paid the tax. *See Doyon, Ltd. v. United States,* 37 Fed.Cl. 10, 22–24 (1996), *rev'd on other grounds,* 214 F.3d 1309 (Fed.Cir.2000). In *Doyon,* the Court of Federal Claims rejected a taxpayer's argument that certain payments to it from other private parties should have been allowed as an adjustment to its net book income for tax purposes

[4] There is no dispute that the U.K. tax authorities did not authorize or participate in any way in the actual calculation or execution of the Barclays payment.

because the payments were effectively the same as a tax item in substance. Contrary to its argument in this case, the government contended in *Doyon* that "amounts paid between private parties pursuant to private contracts are not and cannot be 'federal income taxes' " within the meaning of the applicable Code provision and related regulations. *Id.* at 17 (summarizing the government's contention). The court there agreed with the government that private payments were not tax items, concluding that "an item of federal tax benefit is an abatement of liability under the revenue laws," and further that even if the federal Treasury could be regarded as the "ultimate source" of the private party payment, the payment was still private and therefore not a tax item. *Id.* at 22–23. Sovereign also cites some private letter rulings that similarly look to whether the taxing authority was actually a party to a transfer of a payment or credit, and not to the economic substance of the event, to determine whether the matter was a tax item or a private transaction. *See* I.R.S. Priv. Ltr. Rul. 2009–51–024 (Dec. 18, 2009); I.R.S. Priv. Ltr. Rul. 2003–48–002 (Nov. 28, 2003); I.R.S. Priv. Ltr. Rul. 87–42–010 (July 10, 1987).

Slight as this authority may be, it is enough to outweigh the government's authority for its proposition that a private payment may be recharacterized into a tax item, which is nil. The recent decisions in similar STARS cases do not discuss the issue. *See Salem Fin., Inc. v. United States,* 112 Fed.Cl. 543, 585–87 (2013); *Bank of N.Y. Mellon Corp. v. C.I.R.,* 140 T.C. 15, 40–43 (Feb. 11, 2013). Those cases appear to deal with the question whether the Barclays payment was "in substance" a

"tax effect" as a matter of *fact,* rather than as a matter of *law,* as I conclude is proper. In other words, they accept the testimony of the government's experts and make a factual finding that the Barclays payment was an effective U.K. tax rebate and consequently a U.S. tax effect. *Salem Fin.,* 112 Fed.Cl. at 586–87; *Bank of N.Y.,* 140 T.C. at 43. Notably, they do not address the legal question whether a private party payment between Barclays and the relevant bank can properly be classified as a tax effect because it is so much like one in substance, a question that *Doyon* and the private letter rulings answer in the negative.

Moreover, the Code and regulations have addressed the issues of rebates and subsidies and stopped short of any concept of "constructive" or "effective" rebate. If there were to be such a new principle adopted, and it would be a new principle, it would be better done through the legislative and rulemaking processes where the focus is broad, rather than through adjudication where the focus is particular and possibly outcome-driven.

The economic substance doctrine allows the government to look beyond technical compliance with the Code to ascertain the real nature of the transaction at issue. However, economic substance still must be assessed in adherence to accepted and usual legal and accounting principles. *See Compaq Computer Corp. & Subsidiaries v. C.I.R.,* 277 F.3d 778, 784–86 (5th Cir.2001). Otherwise, the government's "trump card" would acquire too much potency. Here, treating the Barclays payment as revenue to the taxpayer is not a manipulative distortion of the tax rules to achieve merely technical

compliance, but rather is fully consistent with not only the letter but the substance of the IRS's own regulations and existing case law. *See Compaq Computer Corp. & Subsidiaries,* 277 F.3d at 784–85 (collecting cases); *IES Indus., Inc.,* 253 F.3d at 354; 26 U.S.C. § 61(a)(12); 26 C.F.R. § 1.901–2(f)(1)–(2)(i).

Barclays' assumption of part of Sovereign's tax liability is properly regarded as income to Sovereign. It is a hoary principle dating to the earliest days of the income tax that taxes paid on behalf of a taxpayer are counted as income to the taxpayer. *Old Colony Trust Co. v. C.I.R.,* 279 U.S. 716, 729, 49 S.Ct. 499, 73 L.Ed. 918 (1929). It is still vital. *See IES Indus., Inc. v. United States,* 253 F.3d 350, 354 (8th Cir.2001); *accord Compaq Computer Corp. & Subsidiaries,* 277 F.3d at 784.

This principle is also reflected in the IRS's own regulations. Treas. Reg. § 1.901–2(f)(1) provides:

> The person by whom tax is considered paid for purposes of sections 901 and 903 is the person on whom foreign law imposes legal liability for such tax, even if another person (e.g., a withholding agent) remits such tax.... [T]he person on whom foreign law imposes such liability is referred to as the "taxpayer."

Further, Treas. Reg. § 1.901–2(f)(2) provides:

> Tax is considered paid by the taxpayer even if another party to a direct or indirect transaction with the taxpayer agrees, as a part of the transaction, to

> assume the taxpayer's foreign tax liability.

The government makes no attempt to explain why the *Old Colony* principle or these regulations should not apply. *See Compaq Computer Corp. & Subsidiaries,* 277 F.3d at 784 (finding economic substance based on the *Old Colony* principle; "the payment of Compaq's Netherlands tax obligation by Royal Dutch was income to Compaq."). Rather, it apparently asks the Court to apply a new *ad hoc* theory to the STARS transactions, even if that means ignoring long established principles, including those it has embraced in its regulations and advocated in prior cases. Those principles hold that payments between private parties, even if they are buying and selling tax credits, are income to be accounted for on a pre-tax basis. Under those principles, the Barclays payment is properly accounted for as pre-tax income to Sovereign, and not as a tax rebate.

The government also advances a more generalized "sham" argument, as it did in the *Bank of New York* and *Salem Financial* cases. Under this broad view, the whole STARS transaction was concocted to manufacture a bogus foreign tax credit for Sovereign. There was no legitimate business purpose or economic substance to the transaction, the argument goes, except to create the conditions under which Sovereign could claim the foreign tax credit on its U.S. returns. The courts in the other cases apparently were persuaded to that position, but I am not. In part the argument is foreclosed by what has just been explained. If the Barclays payment is included in the calculation of pre-tax profitability, then there was a

reasonable prospect of profit as to the trust transaction, giving it economic substance. But in any event, unless the "effective rebate" theory is credited, Sovereign's payment of the U.K. tax and claiming of the U.S. foreign tax credit did not produce an improper tax benefit; rather, it was simply a wash. Even if the Barclays payment was intended to be and was the assumption of part of Sovereign's U.K. tax burden (which Sovereign concedes for the purposes of this motion), Sovereign is nonetheless treated as having paid the full U.K. tax for purposes of the foreign tax credit. *See* Treas. Reg. § 1.901–2(f)(1), (2). It was thus entitled to claim the foreign tax credit on its U.S. returns. It is true that the U.K. received an amount in taxes from Sovereign that but for the transaction would have gone to the U.S. Treasury, but that transfer produced no advantage to Sovereign. It was still out the same amount of tax, regardless of which country it was paid to.

One final matter. It might be suggested that the "economic substance" or "substance over form" test requires, in addition to an assessment of the objective economic realities of a transaction, an inquiry into the subjective motivation or purpose of the taxpayer, and that this need for a subjective inquiry raises fact issues that should preclude summary judgment. I disagree.

It is clear that cases dealing with the economic substance question *always* assess the objective economic reality of the transaction to determine whether it is in actuality a legitimate or a "sham" transaction. *Sometimes* the cases also assess the taxpayer's subjective purpose or motivation, and they

often give that assessment different degrees of significance in their ultimate judgment. Older First Circuit cases seem to emphasize reliance on objective assessment virtually to the exclusion of subjective assessment. *Stone v. C.I.R.,* 360 F.2d 737, 740 (1st Cir.1966); *Fabreeka Prods. Co. v. C.I.R.,* 294 F.2d 876, 878–79 (1st Cir.1961); *Granite Trust Co. v. United States,* 238 F.2d 670, 678 (1st Cir.1956). Both parties try to find advantage in then-Judge Breyer's opinion in *Dewees v. C.I.R.,* 870 F.2d 21 (1st Cir.1989), Sovereign arguing that a close reading shows that the court confirmed the Circuit's prior objective-only approach, the government, relying on the opinion of Judge Saylor in *Fid. Int'l Currency Advisor A Fund, LLC,* 747 F.Supp.2d at 228–31, arguing that a more expansive reading indicates that *Dewees* "effectively" (there is that word again) overruled the prior cases. I find neither position completely persuasive. The "sham in substance" doctrine was not a central focus of the decision in *Dewees,* and my own reading of the opinion does not leave me with the sense that the court was trying to lay out a full statement of the doctrine, either in light of the prior cases or in spite of them.

If the First Circuit has occasion to address the doctrine again (as I suspect it will), I would guess that it would perhaps move a bit away from a rigid "objective only" test to one that is primarily objective but has room for consideration of subjective factors where necessary or appropriate. Nonetheless, in the circumstance where it found that the objective assessment established that the transaction *lacked* economic substance independent of tax considerations, the court did say that a subjective

inquiry may be dispensed with. *Dewees,* 870 F.2d at 35 ("Where the objective features of the situation are sufficiently clear, [the Tax Court] has the legal power to say that self-serving statements from taxpayers could make no legal difference...."). In light of that dispensation, I would not expect it to insist on consideration of the subjective intent of a taxpayer where the transaction is objectively judged *to have had* economic substance. More specifically, I have no reason to think that the First Circuit would be inclined to follow the Sixth Circuit's proposition stated in *Dow Chem. Co. v. United States,* that "[i]f the transaction has economic substance, 'the question becomes whether the taxpayer was motivated by profit to participate in the transaction.' " 435 F.3d 594, 599 (6th Cir.2006) (quoting *Illes v. C.I.R.,* 982 F.2d 163, 165 (6th Cir.1992)).[5] Obviously, I do not follow that proposition here. For this reason, there is no need for a trial to conduct a subjective inquiry.

For the foregoing reasons, Sovereign's motion for partial summary judgment (dkt. no. 124) has been granted.

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[5] The Sixth Circuit's position in this respect is of dubious provenance. It traces back to a rather summary opinion in *Mahoney v. C.I.R.,* 808 F.2d 1219 (6th Cir.1987), which, like *Dewees,* was concerned with the "entered into for profit" language of Code § 165(c). The *Mahoney* court apparently thought that statutory phrase required consideration of a subjective motive. That will not always be necessary, and perhaps even never so, in the broader, *Gregory*-based inquiry into economic substance.

Appendix C

United States District Court,
D. Massachusetts.

Santander Holdings USA, Inc. & Subsidiaries,
Plaintiff,

v.

United States of America, Defendant.

CIVIL ACTION NO. 09-11043-GAO

Signed November 13, 2015

OPINION AND ORDER

O'TOOLE, D.J.

Santander Holdings USA, Inc., formerly known as Sovereign Bancorp, Inc., and referred to in this opinion as "Sovereign," has sued to recover approximately $234 million in federal income taxes, penalties, and interest that it claims were improperly assessed and collected by the Internal Revenue Service for tax years 2003, 2004, and 2005 as a result of the IRS's disallowance of foreign tax credits claimed by Sovereign for those years. The tax credits were claimed as a consequence of Sovereign's participation in a "Structured Trust Advantaged Repackaged Securities" ("STARS") transaction that was sponsored by Barclays Bank PLC. The STARS transaction has been summarized by this Court, see Santander Holdings USA, Inc. & Subsidiaries v. United States, 977 F.Supp.2d 46, 48–49 (D.Mass.2013), and other courts, see Bank of N.Y.

Mellon Corp. v. Comm'r, 801 F.3d 104, 110–12 (2d Cir.2015), *petitions for cert. filed* (U.S. Oct. 13, 2015) (No. 15-478); (U.S. Nov. 2, 2015) (No. 15-572); Salem Fin., Inc. v. United States, 786 F.3d 932, 937–39 (Fed.Cir.2015), *petition for cert. filed* (U.S. Sept. 29, 2015) (No. 15-380); Wells Fargo & Co. v. United States, No. 09–CV–2764, 2015 WL 6962838 (D.Minn. Nov. 10, 2015), and there is no need to repeat the description here. Familiarity with those summary descriptions is assumed.

This Court previously granted Sovereign's motion for partial summary judgment as to whether the "Barclays payment" (also known as the "bx payment") should be accounted for as revenue to Sovereign in assessing whether Sovereign had a reasonable prospect of profit in what the parties refer to as the "trust transaction." I agreed with Sovereign that the Barclays payment should be accounted for as pretax revenue, which meant that the trust transaction showed a reasonable prospect of profit and therefore did not, as the government had argued, lack economic substance. In reaching that conclusion, I rejected the government's argument that the Barclays payment should be treated as an "effective rebate" of U.K. taxes paid by Sovereign and thus a "tax effect" that should not be taken into account in determining Sovereign's pretax revenues from the trust transaction and consequently the transaction's prospect of profit. Santander Holdings, 977 F.Supp.2d at 50–53.

Thereafter, Sovereign moved for summary judgment on Counts One, Two, Three, and Seven of its Amended Complaint. Counts One through Three are claims for refunds of taxes paid in 2003, 2004, and 2005,

respectively, and Count Seven is a claim for a refund of deficiency interest assessed by the IRS.[1]

The government opposed Sovereign's motion and cross-moved for partial summary judgment in its favor on the following issues: "(1) whether the step transaction doctrine applies to require some or all of the steps of Sovereign's STARS Trust be disregarded for federal income tax and for U.S.-U.K. Tax Treaty purposes; (2) whether the conduit doctrine applies to require the Sovereign's STARS Trust be treated as a mere conduit, and, as a consequence, be disregarded for federal income tax and for U.S.-U.K. Tax Treaty purposes[;] and (3) whether a full computation of Sovereign's potential profit from the STARS transaction requires ... [the income from the Barclays payment to] be reduced by the costs incurred to earn it, most notably, Sovereign's payment of U.K. trust tax." (United States' Cross Mot. for Partial Summ. J. at 1 (dkt. no. 249).) The government also objected that summary judgment in Sovereign's favor was inappropriate because there remained issues of fact as to whether the STARS loan transaction lacked economic substance. I address these issues in reverse order.

<u>I. The Economic Substance of the Loan Transaction</u>

There is no factual dispute that in the STARS loan transaction, Sovereign borrowed from Barclays over a billion dollars that it used in its banking operations. I

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[1] If Sovereign succeeds on the first three Counts, it acknowledges that Counts Four, Five, and Six, which present alternative claims, will be moot.

agree with both the Second and Federal Circuits, as well as the Tax Court, that this fact by itself is sufficient to reject the claim that the loan lacked economic substance, even when the loan transaction is considered apart from the trust transaction. See Bank of N.Y. Mellon, 801 F.3d at 123–24 (affirming Bank of N.Y. Mellon Corp. v. Comm'r, 106 T.C.M. (CCH) 367 (T.C. 2013)); Salem Fin., 786 F.3d at 957.

As the Federal Circuit noted, the STARS transaction as originally designed was marketed to non-bank businesses and did not include a loan transaction, and Barclays was unsuccessful in attracting interested companies. Salem Fin., 786 F.3d at 936, 957. The design was modified to include a loan transaction, and banks then became interested, as these cases demonstrate. It is an obvious and fair conclusion that it was the economic value of the loan that attracted their attention.

The government points out that the nominal loan interest rates on both the original borrowing and the extension were higher than rates available to Sovereign for conventional (that is to say, non-STARS) borrowing. Even so, to say that the loan was priced too high[2] is not the equivalent of saying that it lacked any economic substance. As both the Second and Federal Circuits recognized, see Bank of N.Y. Mellon, 801 F.3d at 123–24; Salem Fin., 786 F.3d at

[2] Of course, the loan can only be considered to be priced too high if one looks only at its nominal rate, and not at its effective rate if the Barclays payment is included in the analysis. But even viewed through the lens of bifurcation, price is not the only measure of whether there was a transaction with genuine economic substance.

957, it was a real loan. It furnished the bank with capital to invest in its business that had to be paid back. It was a substantive economic transaction.[3]

II. Economic Substance of the Trust Transaction, Redux

In ruling on the prior motion for partial summary judgment, I concluded that the Barclays payment should be accounted for as revenue to Sovereign in assessing whether there was a reasonable prospect of profit in the trust transaction because the payment was properly regarded as income under the principle established in Old Colony Trust Co. v. Commissioner, 279 U.S. 716, 729, 49 S.Ct. 499, 73 L.Ed. 918 (1929). Santander Holdings, 977 F.Supp.2d at 52–53. In doing so I rejected the government's argument that the Barclays payment should be excluded from a pretax profit analysis because it was in substance a rebate of part of Sovereign's U.K. taxes and thus a "tax effect" properly omitted from pretax evaluations.

The government also argued that Sovereign's U.K. tax payments should be factored into the pretax profitability assessment not because they were taxes but because they were an economic cost. (See Def. United States' Resp. in Opp'n to Pl.'s Mot. for Partial Summ. J. at 48-49 (dkt. no. 134).) That argument was also implicitly rejected, although it was not specifically addressed in the opinion. The government

[3] "The general characterization of a transaction for tax purposes is a question of law subject to review." Frank Lyon Co. v. United States, 435 U.S. 561, 581 n. 16, 98 S.Ct. 1291, 55 L.Ed.2d 550 (1978); accord IES Indus., Inc. v. United States, 253 F.3d 350, 351 (8th Cir.2001).

renews the argument here, and I now explain why I reject it.

It is true, as the government argues, that the STARS transaction is different from the transactions at issue in Compaq Computer Corp. v. Commissioner, 277 F.3d 778 (5th Cir.2001), and IES Industries, Inc. v. United States, 253 F.3d 350 (8th Cir.2001), which were discussed in the prior ruling regarding the inclusion of the Barclays payment as income in assessing the prospect of pretax profitability. The tax payments at issue in those cases were payments of Netherlands withholding taxes on dividends received by the taxpayers. In other words, they were the taxes paid as a direct consequence of the taxable events that occurred in the course of the arbitrage transactions. In contrast, Sovereign's U.K. tax payments were not occasioned by the receipt of the Barclays payment; they were income taxes incurred by reason of Sovereign's contribution of income-earning assets to the STARS trust, thus subjecting the trust income to U.K. taxation because the trustee was deemed to be a U.K. resident under U.K. law (and the U.S.-U.K. tax treaty). So the government is correct that the Compaq and IES cases do not directly answer the question of whether to treat the payment of U.K. taxes as an expense attributable to the receipt of the Barclays payment.

That said, Sovereign's U.K. tax payments are not properly regarded as an actual economic cost for the Barclays payment to be figured in a profitability assessment. The assets Sovereign contributed to the trust were earning income and Sovereign was being taxed on that income before the STARS transaction.

After the contribution of the assets to the STARS trust, they continued to earn income and Sovereign continued to be taxed on that income. Sovereign's tax burden with respect to the income produced by the trust assets was not affected by the contribution of the assets to the trust. What was changed was that Sovereign was paying taxes on the income from the contributed assets to the U.K. rather than to the U.S. Indeed, it is one of the government's rhetorical flourishes that the STARS transaction "diverted" to the U.K. tax payments that should have gone to the U.S. Treasury, as if the whole point of the purported tax avoidance scheme was to generate an undeserved foreign tax credit and thus to avoid paying a certain amount in taxes to Uncle Sam by paying an equal amount to John Bull. In other words, there is no dispute that Sovereign's overall income tax payments were not increased as a consequence of the transaction. Cf. Wells Fargo, 2015 WL 6962838, at *3 (describing bank's combined tax payments as a "wash"). Put another way, there was no increased *income tax cost* as a consequence of Sovereign entering into the STARS transaction. The cost was simply divided between two taxing authorities, rather than going all to one.

It is therefore inaccurate to say that Sovereign "paid for" the Barclays payment by paying taxes to the U.K. It is certainly true that Sovereign's subjecting the assets contributed to the trust to U.K. taxation was one of the necessary conditions to the generation of Barclays' U.K. tax savings and therefore to the ultimate receipt by Sovereign of the Barclays payment. But the condition was not that Sovereign pay any additional amount in income taxes but rather

that it pay income taxes *to the U.K.* The condition was not economic in its essence, but jurisdictional.[4] The only true economic cost to Sovereign of establishing that necessary jurisdictional condition would have been the transaction costs incurred in negotiating and executing the deal. They were not large enough to alter the prospect of profit in the trust transaction.

Lastly, even if the U.K. taxes were to be treated as an expense to be properly considered in a profitability analysis, it would then be necessary also to consider the effect of the offsetting U.S. foreign tax credit. To do otherwise "is to stack the deck against finding the transaction profitable." Compaq, 277 F.3d at 785. "To be consistent, the analysis should either count all tax effects or not count any of them." Id. The government's argument is circular; it assumes what it seeks to prove: The foreign tax credit should be ignored for purposes of the profitability analysis. Ignoring it, but considering the U.K. taxes paid, the analysis shows lack of a prospect of profit. The transaction thus lacked economic substance. Therefore the foreign tax credit should be ignored.[5]

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[4] Cf. Salem Fin., 786 F.3d at 945 ("The [Barclays] payments were made in consideration of BB&T's services rendered under the STARS transaction, including BB&T's acts of creating the STARS Trust and subjecting its U.S.-based assets to U.K. taxation.").

[5] The court in Wells Fargo seems to make the same circularity error. In describing the STARS transaction in the beginning of its order, the court starts with the observations that "Wells Fargo effectively shifted some of its tax payments out of the U.S. treasury and into the U.K. treasury," 2015 WL 6962838, at *2, that "STARS took money out of the pocket of the U.S. treasury and put that

Put bluntly, the government's bootstrap position is that the tax payment should be included and the tax credit excluded because if that is done, the transaction appears to lack economic substance. It seems that the Second Circuit was persuaded by that argument. See Bank of N.Y. Mellon, 801 F.3d at 118–19.[6] I am not, and apparently the Federal Circuit was not either. See supra note 4.

For these reasons, the amounts paid to the U.K. in taxes by Sovereign should not be included as offsetting costs in an analysis of the prospect of pretax profitability of the trust transaction.

III. Substance over Form Doctrines

It is undisputed that because the trustee of the STARS trust was a resident of the U.K., the trust's income was subject to U.K. taxation. It is undisputed that for the years in question Sovereign actually paid taxes on the trust's income to the U.K.[7] It is

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money into the pockets of Wells Fargo, Barclays, and U.K. treasury," id. at *3, and that "the U.S. treasury funded all of the profits of the STARS transaction," id. at *4. Those characterizations seem more appropriate to the end of the analysis than the beginning.

[6] With all respect, the court's statement that "the trust transaction in BNY had little to no potential for economic return apart from the tax benefits," id. at 119, is not a reason for including tax payments and excluding tax credits but rather a conclusion about what happens *if* the payments are included and the credits are excluded.

[7] It is also undisputed that Sovereign, the parent, disregarded subsidiary entities, including the trust, for U.S. tax purposes, and that it treated the trust income as income to it, and paid both the U.K. and U.S. taxes on that income.

undisputed that the U.K. tax authorities did not rebate any portion of the taxes paid, and I have ruled that the Barclays payment is not properly regarded as an "effective rebate" by Barclays of the trust's U.K. taxes. Santander Holdings, 977 F.Supp.2d at 51–53. Accordingly, it is established that, at least as a prima facie matter, Sovereign was entitled to claim a foreign tax credit under Section 901 of the Internal Revenue Code and related statutory and regulatory provisions for the amounts of foreign tax actually paid to the U.K. for the years in question. 26 U.S.C. § 901 et seq.

Because, as I have said, the Barclays payment was not "in substance" a rebate of U.K. taxes, it was not, therefore, a tax item or effect. A necessary reciprocal corollary of that prior ruling is that Sovereign "in substance" paid all its U.K. income taxes. Payment of foreign taxes is the essential prerequisite to its claim of a foreign tax credit in like amount against its U.S. tax obligations. As Sovereign has pointed out, the government has not proffered any statutory, regulatory, or judicial authority supporting the denial of a credit under Section 901 when as a matter of fact the taxpayer has "in substance"—i.e., actually—paid a foreign tax of the kind designated as eligible for the credit.

Ironically, the government invokes two "substance over form" doctrines—the "step transaction" and the "conduit" doctrines—to support its argument that the substance of Sovereign's actual payment of U.K. taxes should be ignored in assessing whether Sovereign properly claimed foreign tax credits. Briefly, those doctrines hold that transactions that proceed through multiple steps or involve the interaction of a sequence

of multiple entities ("conduits") or both can be examined at each step and as to each entity to see whether the step or the entity is included for a genuine business or economic non-tax reason or whether the step or entity is employed only to contrive a tax benefit that a more direct transaction would not yield. The doctrines cannot help the government as it proposes.

First, for purposes of Sovereign's payment of its U.S. taxes, the doctrines are beside the point. The STARS trust created by Sovereign was "disregarded" for U.S. tax purposes, as authorized under Treasury Regulation § 301.7701–2(a). (Pl.'s Mem. of Law in Supp. of Mot. for Partial Summ. J. Ex. 4 (Aff. Of Kurt J. Swartz) at 3 (dkt. no. 127-5).) Consequently, all of the trust's income, expenses, liabilities, and assets were treated for tax purposes as owned directly by Sovereign. Accordingly, for U.S. tax purposes, there are no steps to collapse or conduits to ignore. Neither the existence of the trust nor the fact that its trustee was a U.K. resident factored into the computation of Sovereign's U.S. tax obligations.

Nor do the step transaction and conduit doctrines provide a basis for disregarding Sovereign's actual payment of U.K. taxes. The doctrines permit ignoring unnecessary steps or entities. Their justification—that the real, and not artificial, nature of transactions is to be evaluated—does not extend to disregarding events with real economic consequences such as Sovereign's actual payment of real money in taxes to the U.K.

It is understandable that the circular STARS trust—Barclays distributions and recontributions that led to Barclays' obtaining a substantial benefit under U.K. tax laws have aroused instincts of disapproval in people familiar with how American judicial anti-abuse doctrines operate as a bulwark against the manipulation of the U.S. tax code to produce unintended tax benefits. But there is nothing in this case that suggests that Barclays' obtaining of that substantial benefit was anything other than fully in accord with U.K. tax law, or that that country's tax law was abusively manipulated. Apparently, unlike U.S. law, U.K. tax law tends primarily to recognize the *form* of a transaction, and does not generally engage in substance over form recharacterization. It is undisputed in this case that the U.K. tax authorities did not challenge the Barclays-trust machinations as illegitimate under U.K. law.

What the government argues for is application of U.S. judicial doctrine to examine the computation of Barclays' U.K. tax liability. The argument itself is a bit of misdirection. As noted, the steps and conduits involved in the STARS transaction affected *Barclays'* U.K. tax liabilities (and benefits), not Sovereign's. It should be remembered that the STARS transaction was developed by Barclays and marketed to U.S. banks, including Sovereign. It was Barclays that was interested in obtaining tax benefits under its own domestic law. The STARS transaction was not developed because U.S. taxpayers were looking for ways to game the U.S. tax code. The participating banks simply counted on the foreign tax credit to assure tax neutrality.

Moreover, unlike many circumstances in which the anti-abuse doctrines are used to collapse or ignore meaningless steps and conduits, the participants in the STARS trust-Barclays transaction were arm's length counterparties, not related entities. They had their own distinct interests. Barclays was interested in tax benefits it could obtain under U.K. law, in exchange for which it was prepared to pay a U.S. bank counterparty for its cooperation in a transaction that would produce those benefits. Separately, the bank counterparty was interested in lower cost borrowing. In other words, the act of voluntarily "subjecting itself" to U.K. taxes was Sovereign's quid for Barclays' quo.[8] There was a genuine non-tax, business purpose for Sovereign's participation in the STARS transaction.

The government argues that Sovereign agreed with Barclays to participate in the STARS transaction in order to "generate" a foreign tax credit under Section 901. But it is fanciful to say that Sovereign had a U.S. tax motive. In the first place, as already noted, Sovereign effectively paid the same total amount in income taxes as it would have without the STARS transaction. It is just that as a result of the transaction, it paid that same amount to two different taxing authorities. It did not *avoid* any tax or reduce its income tax cost. Similarly, it makes no sense to say that Sovereign's motive was to "divert" tax payments from the U.S. to the U.K., just so that it could get an aliquot credit against its U.S. tax bill. Not only would that wash flow be pointless in and of itself, but

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[8] See supra note 4.

transaction costs would necessarily make it uneconomical.

Of course Sovereign took into account in deciding to participate in the STARS transaction that the U.S. tax code provides a credit for amounts of foreign income taxes paid, and *of course* it would not likely have participated in the transaction if it expected to be doubly taxed on the trust's income. The fact that it considered the credit does not mean that its motive was simply to obtain the credit. What keeps tax lawyers in business is that people have to consider the tax consequences of the actions they take. See Frank Lyon Co. v. United States, 435 U.S. 561, 580, 98 S.Ct. 1291, 55 L.Ed.2d 550 (1978) ("The fact that favorable tax consequences were taken into account by Lyon on entering into the transaction is no reason for disallowing those consequences. We cannot ignore the reality that the tax laws affect the shape of nearly every business transaction."). A person making an economic decision about whether to rent or buy a house may consider that the mortgage interest deduction makes buying more financially attractive. Expecting the tax benefit does not make deciding to buy a house a tax-motivated decision. It is likely that every U.S. taxpayer that has foreign income subject to foreign taxation considers the benefit of the foreign tax credit before undertaking the transaction that will generate that income. The characterization the government uses to condemn Sovereign's actions in the STARS transaction is not limited to the STARS transaction; it logically applies any time a business intentionally "subjects itself" to foreign taxation in the course of its business operations.

Moreover, the objection that Sovereign did not engage in "purposive activity" is incorrect. As has been discussed, it borrowed money at a cost that was in the end advantageous, and as previously discussed, the STARS transaction, taken either as bifurcated or as a whole, had substantial economic value to Sovereign.

As the foregoing indicates, I take a substantially different view of the issues from that taken by other courts that have considered the government's arguments about whether the STARS transaction should be declared abusive insofar as U.S. tax law is concerned. Let me recap my principal (and principle) disagreements with those cases. First, I do not regard it to be an abuse under U.S. tax law for an American taxpayer to voluntarily cause U.S. source income to become foreign source income when that is done for real non-tax business reasons, as I have explained. The Salem Financial court apparently thought that "the Trust transaction reflected no meaningful economic activity" by the bank in that case. 786 F.3d at 951. I think that statement is inconsistent with the court's earlier statement, quoted in footnote 4 supra, that the bank made the Barclays payment "in consideration of [the bank's] services rendered under the STARS transaction." Id. at 945. Being compensated for services rendered seems like "meaningful economic activity" to me.

I also disagree with the breadth of the Salem Financial court's statement that "the Trust transaction was a contrived transaction performing no economic or business function other than to generate tax benefits." Id. at 951. That characterization is perhaps true as applied to

Barclays, but not to Sovereign, for the reasons I have explained.

And finally, for the same reasons, I disagree with the Salem Financial court that "the STARS Trust had no non-tax business purpose, and that, instead, its sole function was 'to self-inflict U.S.-sourced [bank] income in order to reap U.S. and U.K. tax benefits.' " Id. (quoting Court of Federal Claims' finding in Salem Fin., Inc. v. United States, 112 Fed.Cl. 543, 587 (2013)). The trust transaction brought Sovereign the Barclays payment, a substantial economic benefit.

Similarly, I think the court in Bank of New York Mellon did not properly distinguish the separate interests of the participating bank and Barclays and the differing significance of the STARS transaction for each. It apparently agreed with the Tax Court's finding "that the transaction's circular cash flow strongly indicated that its main purpose was to generate tax benefits for [the bank] and Barclays." 801 F.3d at 122. The "circular flows" did not generate any tax benefit for the bank, though they did for Barclays. The bank, in this case Sovereign, did not get *any* U.K. tax benefits; it *paid* U.K. taxes that were not rebated by the U.K. And its U.S. tax benefit was limited to the ability to offset otherwise due U.S. taxes by a foreign tax credit under Section 901, a benefit that is a product of the Internal Revenue Code, not the STARS transaction.

Second, I do not think it is necessary or appropriate to apply American judicial anti-abuse doctrines to analyze Barclays' structuring of its U.K. tax liabilities so as to obtain benefits that are so far as appears

entirely proper under U.K. law when that structuring itself had no effect on Sovereign's overall tax liabilities.

The Salem Financial, Bank of New York Mellon, and Wells Fargo cases illustrate, I think, that the judicial anti-abuse doctrines—whether substance over form or economic substance—can themselves be susceptible to abuse. Both circuit courts outlined what the latter opinion called "the core principles of the economic substance doctrine":

> The critical question is not whether the transaction would produce a net gain after all tax effects are taken into consideration; instead the pertinent questions are [1] whether the transaction has real economic effects apart from its tax effects, [2] whether the transaction was motivated only by tax considerations, and [3] whether the transaction is the sort that Congress intended to be the beneficiary of the foreign tax credit provision.

Bank of N.Y. Mellon, 801 F.3d at 117 (quoting Salem Fin., 786 F.3d at 948). In the discussion above, I have addressed the first two principles. Those principles can be evaluated by objective analysis of the facts of the case. The third principle can turn in large part on whether a court subjectively thinks the transaction being examined is "the sort that Congress intended to be the beneficiary of the foreign tax credit provision." See id.

There is no need to speculate here. We know what Congress intended in authorizing the foreign tax credit. As the government has acknowledged in its briefing, Congress intended to provide relief against possible double taxation and thus "to neutralize the effect of U.S. taxes on decisions regarding where to invest or conduct business." (United States' Reply in Supp. of Cross Mot. for Partial Summ. J. at 5 (dkt. no. 258).)[9] The government asserts that "it is an abuse of the foreign tax credit if the taxpayer uses it solely to choose where to pay tax." (Id.) Maybe. But that *reductio ad absurdum* does not accurately describe the STARS transaction. Sovereign did more than solely decide where to pay tax. It chose to enter an arm's length transaction with a foreign counterparty that had, as described above, genuine economic substance that produced real value to Sovereign. As a consequence of entering the transaction with a foreign counterparty, Sovereign incurred and paid foreign income taxes for the years in question. Application of the foreign tax credit to its U.S. tax liability would avoid what it is quite clear Congress intended should be avoided: double taxation of the same income. It is the government's position that is not aligned with congressional intent. What the government is actually defending in these STARS cases is double taxation.

Throughout the government's arguments in this case there has been an undertone of indignation, suggesting that the issues in the case are as much a matter of moral judgment as legal. The "flexible" anti-

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[9] (See also Pl.'s Mem. of Law in Supp. of Mot. for Summ. J. at 11 & n.25 (dkt. no. 246).)

abuse doctrines, Bank of N.Y. Mellon, 801 F.3d at 115, are invoked to make complicated what can rationally be seen as rather simple: if you have actually paid a foreign income tax properly levied by another country, you are entitled to a credit against your U.S. taxes on the same income consistent with the applicable statutes and rules. What seems to bother the government is not so much that Sovereign does not *qualify* for foreign tax credits as that it does not *deserve* them. It is almost as if the government thinks that, under a sort of aiding and abetting theory, Sovereign should be punished by taking away its credit for helping Barclays manipulate *its* benefits under the U.K. tax laws.

The judicial anti-abuse doctrines are important, but their employment should be analytical and not visceral. Among other things, too-ready resort to the government's "trump card," see In re CMI Holdings, Inc., 301 F.3d 96, 102 (3d Cir.2002) (describing the economic substance doctrine as the government's "trump card"), may lead to the ad hoc development of novel principles of judgment solely on the basis of their utility for the particular case at hand. One serious risk is that the ultimate standard of decision becomes a kind of smell test, with the judge's nose ending up the crucial determinant of the outcome. The more that is the case, the less predictability there is in the law, and predictability is a high value in tax law.

IV. Summary of Conclusions and Order

As set forth in section I above, the loan transaction was legitimate, and Sovereign was entitled to deduct the interest expense for the loan.

As set forth in sections II and III above, the government's economic substance and substance over form arguments are unpersuasive. What may appear horribly complicated is really quite simple. Sovereign incurred and paid income taxes to the U.K. for the years in question as a result of a business transaction with a U.K. counterparty, and under Section 901 and related provisions it is entitled to a credit against its U.S. income taxes for those years.

Because the foreign tax credits and the interest deductions were properly claimed, Sovereign should not be assessed penalties and may recover those.

Accordingly, Sovereign's Motion for Summary Judgment (dkt. no. 245) is GRANTED. The government's Cross Motion for Partial Summary Judgment (dkt. no. 249) is DENIED.

Sovereign shall submit a proposed form of judgment within twenty-one (21) days of the entry of this order.

It is SO ORDERED.

Appendix D

26 U.S.C.A. § 901, I.R.C. § 901

§ 901. Taxes of foreign countries and of possessions of United States

Effective: August 10, 2010

(a) Allowance of credit.--If the taxpayer chooses to have the benefits of this subpart, the tax imposed by this chapter shall, subject to the limitation of section 904, be credited with the amounts provided in the applicable paragraph of subsection (b) plus, in the case of a corporation, the taxes deemed to have been paid under sections 902 and 960. Such choice for any taxable year may be made or changed at any time before the expiration of the period prescribed for making a claim for credit or refund of the tax imposed by this chapter for such taxable year. The credit shall not be allowed against any tax treated as a tax not imposed by this chapter under section 26(b).

(b) Amount allowed.--Subject to the limitation of section 904, the following amounts shall be allowed as the credit under subsection (a):

(1) Citizens and domestic corporations.--In the case of a citizen of the United States and of a domestic corporation, the amount of any income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country or to any possession of the United States; and

(2) Resident of the United States or Puerto Rico.--In the case of a resident of the United States

and in the case of an individual who is a bona fide resident of Puerto Rico during the entire taxable year, the amount of any such taxes paid or accrued during the taxable year to any possession of the United States; and

(3) Alien resident of the United States or Puerto Rico.--In the case of an alien resident of the United States and in the case of an alien individual who is a bona fide resident of Puerto Rico during the entire taxable year, the amount of any such taxes paid or accrued during the taxable year to any foreign country; and

(4) Nonresident alien individuals and foreign corporations.--In the case of any nonresident alien individual not described in section 876 and in the case of any foreign corporation, the amount determined pursuant to section 906; and

(5) Partnerships and estates.--In the case of any person described in paragraph (1), (2), (3), or (4), who is a member of a partnership or a beneficiary of an estate or trust, the amount of his proportionate share of the taxes (described in such paragraph) of the partnership or the estate or trust paid or accrued during the taxable year to a foreign country or to any possession of the United States, as the case may be. Under rules or regulations prescribed by the Secretary, in the case of any foreign trust of which the settlor or another person would be treated as owner of any portion of the trust under subpart E but for section 672(f), the allocable amount of any income, war profits, and excess profits taxes imposed by any foreign country

or possession of the United States on the settlor or such other person in respect of trust income.

(c) Similar credit required for certain alien residents.--Whenever the President finds that--

(1) a foreign country, in imposing income, war profits, and excess profits taxes, does not allow to citizens of the United States residing in such foreign country a credit for any such taxes paid or accrued to the United States or any foreign country, as the case may be, similar to the credit allowed under subsection (b)(3),

(2) such foreign country, when requested by the United States to do so, has not acted to provide such a similar credit to citizens of the United States residing in such foreign country, and

(3) it is in the public interest to allow the credit under subsection (b)(3) to citizens or subjects of such foreign country only if it allows such a similar credit to citizens of the United States residing in such foreign country,

the President shall proclaim that, for taxable years beginning while the proclamation remains in effect, the credit under subsection (b)(3) shall be allowed to citizens or subjects of such foreign country only if such foreign country, in imposing income, war profits, and excess profits taxes, allows to citizens of the United States residing in such foreign country such a similar credit.

(d) Treatment of dividends from a DISC or former DISC.--For purposes of this subpart, dividends from a DISC or former DISC (as defined in section 992(a)) shall be treated as dividends from a foreign corporation to the extent such dividends are treated under part I as income from sources without the United States.

(e) Foreign taxes on mineral income.--

(1) Reduction in amount allowed.--Notwithstanding subsection (b), the amount of any income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country or possession of the United States with respect to foreign mineral income from sources within such country or possession which would (but for this paragraph) be allowed under such subsection shall be reduced by the amount (if any) by which--

(A) the amount of such taxes (or, if smaller, the amount of the tax which would be computed under this chapter with respect to such income determined without the deduction allowed under section 613), exceeds

(B) the amount of the tax computed under this chapter with respect to such income.

(2) Foreign mineral income defined.--For purposes of paragraph (1), the term "foreign mineral income" means income derived from the extraction of minerals from mines, wells, or other natural deposits, the processing of such minerals into their primary products, and the

transportation, distribution, or sale of such minerals or primary products. Such term includes, but is not limited to--

(A) dividends received from a foreign corporation in respect of which taxes are deemed paid by the taxpayer under section 902, to the extent such dividends are attributable to foreign mineral income, and

(B) that portion of the taxpayer's distributive share of the income of partnerships attributable to foreign mineral income.

(f) Certain payments for oil or gas not considered as taxes.--Notwithstanding subsection (b) and sections 902 and 960, the amount of any income, or profits, and excess profits taxes paid or accrued during the taxable year to any foreign country in connection with the purchase and sale of oil or gas extracted in such country is not to be considered as tax for purposes of section 275(a) and this section if--

(1) the taxpayer has no economic interest in the oil or gas to which section 611(a) applies, and

(2) either such purchase or sale is at a price which differs from the fair market value for such oil or gas at the time of such purchase or sale.

(g) Certain taxes paid with respect to distributions from possessions corporations.--

(1) In general.--For purposes of this chapter, any tax of a foreign country or possession of the United

States which is paid or accrued with respect to any distribution from a corporation--

(A) to the extent that such distribution is attributable to periods during which such corporation is a possessions corporation, and

(B)(i) if a dividends received deduction is allowable with respect to such distribution under part VIII of subchapter B, or

(ii) to the extent that such distribution is received in connection with a liquidation or other transaction with respect to which gain or loss is not recognized, shall not be treated as income, war profits, or excess profits taxes paid or accrued to a foreign country or possession of the United States, and no deduction shall be allowed under this title with respect to any amount so paid or accrued.

(2) Possessions corporation.--For purposes of paragraph (1), a corporation shall be treated as a possessions corporation for any period during which an election under section 936 applied to such corporation, during which section 931 (as in effect on the day before the date of the enactment of the Tax Reform Act of 1976) applied to such corporation, or during which section 957(c) (as in effect on the day before the date of the enactment of the Tax Reform Act of 1986) applied to such corporation.

[(h) Repealed. Pub.L. 110-172, § 11(g)(9), Dec. 29, 2007, 121 Stat. 2490]

(i) Taxes used to provide subsidies.--Any income, war profits, or excess profits tax shall not be treated as a tax for purposes of this title to the extent--

(1) the amount of such tax is used (directly or indirectly) by the country imposing such tax to provide a subsidy by any means to the taxpayer, a related person (within the meaning of section 482), or any party to the transaction or to a related transaction, and

(2) such subsidy is determined (directly or indirectly) by reference to the amount of such tax, or the base used to compute the amount of such tax.

(j) Denial of foreign tax credit, etc., with respect to certain foreign countries.--

(1) In general.--Notwithstanding any other provision of this part--

(A) no credit shall be allowed under subsection (a) for any income, war profits, or excess profits taxes paid or accrued (or deemed paid under section 902 or 960) to any country if such taxes are with respect to income attributable to a period during which this subsection applies to such country, and

(B) subsections (a), (b), and (c) of section 904 and sections 902 and 960 shall be applied separately with respect to income attributable to such a period from sources within such country.

(2) Countries to which subsection applies.--

(A) In general.--This subsection shall apply to any foreign country--

(i) the government of which the United States does not recognize, unless such government is otherwise eligible to purchase defense articles or services under the Arms Export Control Act,

(ii) with respect to which the United States has severed diplomatic relations,

(iii) with respect to which the United States has not severed diplomatic relations but does not conduct such relations, or

(iv) which the Secretary of State has, pursuant to section 6(j) of the Export Administration Act of 1979,[1] as amended, designated as a foreign country which repeatedly provides support for acts of international terrorisms.

(B) Period for which subsection applies.--This subsection shall apply to any foreign country described in subparagraph (A) during the period--

(i) beginning on the later of--

(I) January 1, 1987, or

(II) 6 months after such country becomes a country described in subparagraph (A), and

[1] Classified to 50 U.S.C.A. § 4605(j).

(ii) ending on the date the Secretary of State certifies to the Secretary of the Treasury that such country is no longer described in subparagraph (A).

(3) Taxes allowed as a deduction, etc.--Sections 275 and 78 shall not apply to any tax which is not allowable as a credit under subsection (a) by reason of this subsection.

(4) Regulations.--The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this subsection, including regulations which treat income paid through 1 or more entities as derived from a foreign country to which this subsection applies if such income was, without regard to such entities, derived from such country.

(5) Waiver of denial.--

(A) In general.--Paragraph (1) shall not apply with respect to taxes paid or accrued to a country if the President--

(i) determines that a waiver of the application of such paragraph is in the national interest of the United States and will expand trade and investment opportunities for United States companies in such country; and

(ii) reports such waiver under subparagraph (B).

(B) Report.--Not less than 30 days before the date on which a waiver is granted under this

paragraph, the President shall report to Congress--

(i) the intention to grant such waiver; and

(ii) the reason for the determination under subparagraph (A)(i).

(k) Minimum holding period for certain taxes on dividends.--

(1) Withholding taxes.--

(A) In general.--In no event shall a credit be allowed under subsection (a) for any withholding tax on a dividend with respect to stock in a corporation if--

(i) such stock is held by the recipient of the dividend for 15 days or less during the 31-day period beginning on the date which is 15 days before the date on which such share becomes ex-dividend with respect to such dividend, or

(ii) to the extent that the recipient of the dividend is under an obligation (whether pursuant to a short sale or otherwise) to make related payments with respect to positions in substantially similar or related property.

(B) Withholding tax.--For purposes of this paragraph, the term "withholding tax" includes any tax determined on a gross basis; but does not include any tax which is in the nature of a prepayment of a tax imposed on a net basis.

(2) Deemed paid taxes.--In the case of income, war profits, or excess profits taxes deemed paid under section 853, 902, or 960 through a chain of ownership of stock in 1 or more corporations, no credit shall be allowed under subsection (a) for such taxes if--

(A) any stock of any corporation in such chain (the ownership of which is required to obtain credit under subsection (a) for such taxes) is held for less than the period described in paragraph (1)(A)(i), or

(B) the corporation holding the stock is under an obligation referred to in paragraph (1)(A)(ii).

(3) 45-day rule in the case of certain preference dividends.--In the case of stock having preference in dividends and dividends with respect to such stock which are attributable to a period or periods aggregating in excess of 366 days, paragraph (1)(A)(i) shall be applied--

(A) by substituting “45 days” for “15 days” each place it appears, and

(B) by substituting “91-day period” for “31-day period”.

(4) Exception for certain taxes paid by securities dealers.--

(A) In general.--Paragraphs (1) and (2) shall not apply to any qualified tax with respect to any security held in the active conduct in a foreign

country of a business as a securities dealer of any person--

(i) who is registered as a securities broker or dealer under section 15(a) of the Securities Exchange Act of 1934,

(ii) who is registered as a Government securities broker or dealer under section 15C(a) of such Act, or

(iii) who is licensed or authorized in such foreign country to conduct securities activities in such country and is subject to bona fide regulation by a securities regulating authority of such country.

(B) Qualified tax.--For purposes of subparagraph (A), the term "qualified tax" means a tax paid to a foreign country (other than the foreign country referred to in subparagraph (A)) if--

(i) the dividend to which such tax is attributable is subject to taxation on a net basis by the country referred to in subparagraph (A), and

(ii) such country allows a credit against its net basis tax for the full amount of the tax paid to such other foreign country.

(C) Regulations.--The Secretary may prescribe such regulations as may be appropriate to carry out this paragraph, including regulations to prevent the abuse of the exception provided by

this paragraph and to treat other taxes as qualified taxes.

(5) Certain rules to apply.--For purposes of this subsection, the rules of paragraphs (3) and (4) of section 246(c) shall apply.

(6) Treatment of bona fide sales.--If a person's holding period is reduced by reason of the application of the rules of section 246(c)(4) to any contract for the bona fide sale of stock, the determination of whether such person's holding period meets the requirements of paragraph (2) with respect to taxes deemed paid under section 902 or 960 shall be made as of the date such contract is entered into.

(7) Taxes allowed as deduction, etc.--Sections 275 and 78 shall not apply to any tax which is not allowable as a credit under subsection (a) by reason of this subsection.

(l) Minimum holding period for withholding taxes on gain and income other than dividends etc.--

(1) In general.--In no event shall a credit be allowed under subsection (a) for any withholding tax (as defined in subsection (k)) on any item of income or gain with respect to any property if--

(A) such property is held by the recipient of the item for 15 days or less during the 31-day period beginning on the date which is 15 days before the date on which the right to receive payment of such item arises, or

(B) to the extent that the recipient of the item is under an obligation (whether pursuant to a short sale or otherwise) to make related payments with respect to positions in substantially similar or related property.

This paragraph shall not apply to any dividend to which subsection (k) applies.

(2) Exception for taxes paid by dealers.--

(A) In general.--Paragraph (1) shall not apply to any qualified tax with respect to any property held in the active conduct in a foreign country of a business as a dealer in such property.

(B) Qualified tax.--For purposes of subparagraph (A), the term "qualified tax" means a tax paid to a foreign country (other than the foreign country referred to in subparagraph (A)) if--

(i) the item to which such tax is attributable is subject to taxation on a net basis by the country referred to in subparagraph (A), and

(ii) such country allows a credit against its net basis tax for the full amount of the tax paid to such other foreign country.

(C) Dealer.--For purposes of subparagraph (A), the term "dealer" means--

(i) with respect to a security, any person to whom paragraphs (1) and (2) of subsection (k)

would not apply by reason of paragraph (4) thereof, and

(ii) with respect to any other property, any person with respect to whom such property is described in section 1221(a)(1).

(D) Regulations.--The Secretary may prescribe such regulations as may be appropriate to carry out this paragraph, including regulations to prevent the abuse of the exception provided by this paragraph and to treat other taxes as qualified taxes.

(3) Exceptions.--The Secretary may by regulation provide that paragraph (1) shall not apply to property where the Secretary determines that the application of paragraph (1) to such property is not necessary to carry out the purposes of this subsection.

(4) Certain rules to apply.--Rules similar to the rules of paragraphs (5), (6), and (7) of subsection (k) shall apply for purposes of this subsection.

(5) Determination of holding period.--Holding periods shall be determined for purposes of this subsection without regard to section 1235 or any similar rule.

(m) Denial of foreign tax credit with respect to foreign income not subject to United States taxation by reason of covered asset acquisitions.--

(1) In general.--In the case of a covered asset acquisition, the disqualified portion of any foreign income tax determined with respect to the income or gain attributable to the relevant foreign assets--

(A) shall not be taken into account in determining the credit allowed under subsection (a), and

(B) in the case of a foreign income tax paid by a section 902 corporation (as defined in section 909(d)(5)), shall not be taken into account for purposes of section 902 or 960.

(2) Covered asset acquisition.--For purposes of this section, the term "covered asset acquisition" means--

(A) a qualified stock purchase (as defined in section 338(d)(3)) to which section 338(a) applies,

(B) any transaction which--

(i) is treated as an acquisition of assets for purposes of this chapter, and

(ii) is treated as the acquisition of stock of a corporation (or is disregarded) for purposes of the foreign income taxes of the relevant jurisdiction,

(C) any acquisition of an interest in a partnership which has an election in effect under section 754, and

(D) to the extent provided by the Secretary, any other similar transaction.

(3) Disqualified portion.--For purposes of this section--

(A) In general.--The term "disqualified portion" means, with respect to any covered asset acquisition, for any taxable year, the ratio (expressed as a percentage) of--

(i) the aggregate basis differences (but not below zero) allocable to such taxable year under subparagraph (B) with respect to all relevant foreign assets, divided by

(ii) the income on which the foreign income tax referred to in paragraph (1) is determined (or, if the taxpayer fails to substantiate such income to the satisfaction of the Secretary, such income shall be determined by dividing the amount of such foreign income tax by the highest marginal tax rate applicable to such income in the relevant jurisdiction).

(B) Allocation of basis difference.--For purposes of subparagraph (A)(i)--

(i) In general.--The basis difference with respect to any relevant foreign asset shall be allocated to taxable years using the applicable cost recovery method under this chapter.

(ii) Special rule for disposition of assets.--Except as otherwise provided by the

Secretary, in the case of the disposition of any relevant foreign asset--

(I) the basis difference allocated to the taxable year which includes the date of such disposition shall be the excess of the basis difference with respect to such asset over the aggregate basis difference with respect to such asset which has been allocated under clause (i) to all prior taxable years, and

(II) no basis difference with respect to such asset shall be allocated under clause (i) to any taxable year thereafter.

(C) Basis difference.--

(i) In general.--The term "basis difference" means, with respect to any relevant foreign asset, the excess of--

(I) the adjusted basis of such asset immediately after the covered asset acquisition, over

(II) the adjusted basis of such asset immediately before the covered asset acquisition.

(ii) Built-in loss assets.--In the case of a relevant foreign asset with respect to which the amount described in clause (i)(II) exceeds the amount described in clause (i)(I), such excess shall be taken into account under this

subsection as a basis difference of a negative amount.

(iii) Special rule for section 338 elections.--In the case of a covered asset acquisition described in paragraph (2)(A), the covered asset acquisition shall be treated for purposes of this subparagraph as occurring at the close of the acquisition date (as defined in section 338(h)(2)).

(4) Relevant foreign assets.--For purposes of this section, the term "relevant foreign asset" means, with respect to any covered asset acquisition, any asset (including any goodwill, going concern value, or other intangible) with respect to such acquisition if income, deduction, gain, or loss attributable to such asset is taken into account in determining the foreign income tax referred to in paragraph (1).

(5) Foreign income tax.--For purposes of this section, the term "foreign income tax" means any income, war profits, or excess profits tax paid or accrued to any foreign country or to any possession of the United States.

(6) Taxes allowed as a deduction, etc.--Sections 275 and 78 shall not apply to any tax which is not allowable as a credit under subsection (a) by reason of this subsection.

(7) Regulations.--The Secretary may issue such regulations or other guidance as is necessary or appropriate to carry out the purposes of this subsection, including to exempt from the application of this subsection certain covered asset

acquisitions, and relevant foreign assets with respect to which the basis difference is de minimis.

(n) Cross reference.--

(1) For deductions of income, war profits, and excess profits taxes paid to a foreign country or a possession of the United States, see sections 164 and 275.

(2) For right of each partner to make election under this section, see section 703(b).

(3) For right of estate or trust to the credit for taxes imposed by foreign countries and possessions of the United States under this section, see section 642(a).

(4) For reduction of credit for failure of a United States person to furnish certain information with respect to a foreign corporation or partnership controlled by him, see section 6038.

Appendix E

26 C.F.R. § 1.901–2, Treas. Reg. § 1.901–2

(excerpts of Sections 1.901-2(e) and 1.901-2(f))

§ 1.901–2 Income, war profits, or excess profits tax paid or accrued.

Effective: September 4, 2013

(e) Amount of income tax that is creditable—(1) In general. Credit is allowed under section 901 for the amount of income tax (within the meaning of paragraph (a)(1) of this section) that is paid to a foreign country by the taxpayer. The amount of income tax paid by the taxpayer is determined separately for each taxpayer.

(2) Refunds and credits—(i) In general. An amount is not tax paid to a foreign country to the extent that it is reasonably certain that the amount will be refunded, credited, rebated, abated, or forgiven. It is not reasonably certain that an amount will be refunded, credited, rebated, abated, or forgiven if the amount is not greater than a reasonable approximation of final tax liability to the foreign country.

(ii) Examples. The provisions of paragraph (e)(2)(i) of this section may be illustrated by the following examples:

Example 1. The internal law of country X imposes a 25 percent tax on the gross amount of interest from sources in country X that is received by a nonresident

of country X. Country X law imposes the tax on the nonresident recipient and requires any resident of country X that pays such interest to a nonresident to withhold and pay over to country X 25 percent of such interest, which is applied to offset the recipient's liability for the 25 percent tax. A tax treaty between the United States and country X overrides internal law of country X and provides that country X may not tax interest received by a resident of the United States from a resident of country X at a rate in excess of 10 percent of the gross amount of such interest. A resident of the United States may claim the benefit of the treaty only by applying for a refund of the excess withheld amount (15 percent of the gross amount of interest income) after the end of the taxable year. A, a resident of the United States, receives a gross amount of 100u (units of country X currency) of interest income from a resident of country X from sources in country X in the taxable year 1984, from which 25u of country X tax is withheld. A files a timely claim for refund of the 15u excess withheld amount. 15u of the amount withheld (25u–10u) is reasonably certain to be refunded; therefore 15u is not considered an amount of tax paid to country X.

Example 2. A's initial income tax liability under country X law is 100u (units of country X currency). However, under country X law A's initial income tax liability is reduced in order to compute its final tax liability by an investment credit of 15u and a credit for charitable contributions of 5u. The amount of income tax paid by A is 80u.

Example 3. A computes his income tax liability in country X for the taxable year 1984 as 100u (units of

country X currency), files a tax return on that basis, and pays 100u of tax. The day after A files that return, A files a claim for refund of 90u. The difference between the 100u of liability reflected in A's original return and the 10u of liability reflected in A's refund claim depends on whether a particular expenditure made by A is nondeductible or deductible, respectively. Based on an analysis of the country X tax law, A's country X tax advisors have advised A that it is not clear whether or not that expenditure is deductible. In view of the uncertainty as to the proper treatment of the item in question under country X tax law, no portion of the 100u paid by A is reasonably certain to be refunded. If A receives a refund, A must treat the refund as required by section 905(c) of the Internal Revenue Code.

Example 4. A levy of country X, which qualifies as an income tax within the meaning of paragraph (a)(1) of this section, provides that each person who makes payment to country X pursuant to the levy will receive a bond to be issued by country X with an amount payable at maturity equal to 10 percent of the amount paid pursuant to the levy. A pays 38,000u (units of country X currency) to country X and is entitled to receive a bond with an amount payable at maturity of 3800u. It is reasonably certain that a refund in the form of property (the bond) will be made. The amount of that refund is equal to the fair market value of the bond. Therefore, only the portion of the 38,000u payment in excess of the fair market value of the bond is an amount of tax paid.

(3) Subsidies—(i) General rule. An amount of foreign income tax is not an amount of income tax

paid or accrued by a taxpayer to a foreign country to the extent that—

(A) The amount is used, directly or indirectly, by the foreign country imposing the tax to provide a subsidy by any means (including, but not limited to, a rebate, a refund, a credit, a deduction, a payment, a discharge of an obligation, or any other method) to the taxpayer, to a related person (within the meaning of section 482), to any party to the transaction, or to any party to a related transaction; and

(B) The subsidy is determined, directly or indirectly, by reference to the amount of the tax or by reference to the base used to compute the amount of the tax.

(ii) Subsidy. The term "subsidy" includes any benefit conferred, directly or indirectly, by a foreign country to one of the parties enumerated in paragraph (e)(3)(i)(A) of this section. Substance and not form shall govern in determining whether a subsidy exists. The fact that the U.S. taxpayer may derive no demonstrable benefit from the subsidy is irrelevant in determining whether a subsidy exists.

(iii) Official exchange rate. A subsidy described in paragraph (e)(3)(i)(B) of this section does not include the actual use of an official foreign government exchange rate converting foreign currency into dollars where a free exchange rate also exists if—

(A) The economic benefit represented by the use of the official exchange rate is not targeted to or tied to transactions that give rise to a claim for a foreign tax credit;

(B) The economic benefit of the official exchange rate applies to a broad range of international transactions, in all cases based on the total payment to be made without regard to whether the payment is a return of principal, gross income, or net income, and without regard to whether it is subject to tax; and

(C) Any reduction in the overall cost of the transaction is merely coincidental to the broad structure and operation of the official exchange rate.

In regard to foreign taxes paid or accrued in taxable years beginning before January 1, 1987, to which the Mexican Exchange Control Decree, effective as of December 20, 1982, applies, see Rev. Rul. 84–143, 1984–2 C.B. 127.

(iv) Examples. The provisions of this paragraph (e)(3) may be illustrated by the following examples:

Example 1. (i) Country X imposes a 30 percent tax on nonresident lenders with respect to interest which the nonresident lenders receive from borrowers who are residents of Country X, and it is established that this tax is a tax in lieu of an income tax within the meaning of § 1.903–1(a). Country X provides the nonresident lenders with receipts upon their payment

of the 30 percent tax. Country X remits to resident borrowers an incentive payment for engaging in foreign loans, which payment is an amount equal to 20 percent of the interest paid to nonresident lenders.

(ii) Because the incentive payment is based on the interest paid, it is determined by reference to the base used to compute the tax that is imposed on the nonresident lender. The incentive payment is considered a subsidy under this paragraph (e)(3) since it is provided to a party (the borrower) to the transaction and is based on the amount of tax that is imposed on the lender with respect to the transaction. Therefore, two-thirds (20 percent/30 percent) of the amount withheld by the resident borrower from interest payments to the nonresidential lender is not an amount of income tax paid or accrued for purposes of section 901(b).

Example 2. (i) A U.S. bank lends money to a development bank in Country X. The development bank relends the money to companies resident in Country X. A withholding tax is imposed by Country X on the U.S. bank with respect to the interest that the development bank pays to the U.S. bank, and appropriate receipts are provided. On the date that the tax is withheld, fifty percent of the tax is credited by Country X to an account of the development bank. Country X requires the development bank to transfer the amount credited to the borrowing companies.

(ii) The amount successively credited to the account of the development bank and then to the account of the borrowing companies is determined by reference to the amount of the tax and the tax base. Since the

amount credited to the borrowing companies is a subsidy provided to a party (the borrowing companies) to a related transaction and is based on the amount of tax and the tax base, it is not an amount paid or accrued as an income tax for purposes of section 901(b).

Example 3. (i) A U.S. bank lends dollars to a Country X borrower. Country X imposes a withholding tax on the lender with respect to the interest. The tax is to be paid in Country X currency, although the interest is payable in dollars. Country X has a dual exchange rate system, comprised of a controlled official exchange rate and a free exchange rate. Priority transactions such as exports of merchandise, imports of merchandise, and payments of principal and interest on foreign currency loans payable abroad to foreign lenders are governed by the official exchange rate which yields more dollars per unit of Country X currency than the free exchange rate. The Country X borrower remits the net amount of dollar interest due to the U.S. bank (interest due less withholding tax), pays the tax withheld in Country X currency to the Country X government, and provides to the U.S. bank a receipt for payment of the Country X taxes.

(ii) The use of the official exchange rate by the U.S. bank to determine foreign taxes with respect to interest is not a subsidy described in paragraph (e)(3)(i)(B) of this section. The official exchange rate is not targeted to or tied to transactions that give rise to a claim for a foreign tax credit. The use of the official exchange rate applies to the interest paid and to the principal paid. Any benefit derived by the U.S. bank through the use of the official exchange rate is merely

coincidental to the broad structure and operation of the official exchange rate.

Example 4. (i) B, a U.S. corporation, is engaged in the production of oil and gas in Country X pursuant to a production sharing agreement between B, Country X, and the state petroleum authority of Country X. The agreement is approved and enacted into law by the Legislature of Country X. Both B and the petroleum authority are subject to the Country X income tax. Each entity files an annual income tax return and pays, to the tax authority of Country X, the amount of income tax due on its annual income. B is a dual capacity taxpayer as defined in § 1.901–2(a)(2)(ii)(A). Country X has agreed to return to the petroleum authority one-half of the income taxes paid by B by allowing it a credit in calculating its own tax liability to Country X.

(ii) The petroleum authority is a party to a transaction with B and the amount returned by Country X to the petroleum authority is determined by reference to the amount of the tax imposed on B. Therefore, the amount returned is a subsidy as described in this paragraph (e)(3) and one-half the tax imposed on B is not an amount of income tax paid or accrued.

Example 5. Assume the same facts as in Example 4, except that the state petroleum authority of Country X does not receive amounts from Country X related to tax paid by B. Instead, the authority of Country X receives a general appropriation from Country X which is not calculated with reference to the amount of tax paid by B. The general appropriation is

therefore not a subsidy described in this paragraph (e)(3).

(v) Effective Date. This paragraph (e)(3) shall apply to foreign taxes paid or accrued in taxable years beginning after December 31, 1986.

(4) Multiple levies—(i) In general. If, under foreign law, a taxpayer's tentative liability for one levy (the "first levy") is or can be reduced by the amount of the taxpayer's liability for a different levy (the "second levy"), then the amount considered paid by the taxpayer to the foreign country pursuant to the second levy is an amount equal to its entire liability for that levy, and the remainder of the amount paid is considered paid pursuant to the first levy. This rule applies regardless of whether it is or is not likely that liability for one such levy will always exceed liability for the other such levy. For an example of the application of this rule, see example 5 of § 1.903–1(b)(3). If, under foreign law, the amount of a taxpayer's liability is the greater or lesser of amounts computed pursuant to two levies, then the entire amount paid to the foreign country by the taxpayer is considered paid pursuant to the levy that imposes such greater or lesser amount, respectively, and no amount is considered paid pursuant to such other levy.

(ii) Integrated tax systems. [Reserved]

(5) Noncompulsory amounts—(i) In general. An amount paid is not a compulsory payment, and thus is not an amount of tax paid, to the

extent that the amount paid exceeds the amount of liability under foreign law for tax. An amount paid does not exceed the amount of such liability if the amount paid is determined by the taxpayer in a manner that is consistent with a reasonable interpretation and application of the substantive and procedural provisions of foreign law (including applicable tax treaties) in such a way as to reduce, over time, the taxpayer's reasonably expected liability under foreign law for tax, and if the taxpayer exhausts all effective and practical remedies, including invocation of competent authority procedures available under applicable tax treaties, to reduce, over time, the taxpayer's liability for foreign tax (including liability pursuant to a foreign tax audit adjustment). Where foreign tax law includes options or elections whereby a taxpayer's tax liability may be shifted, in whole or part, to a different year or years, the taxpayer's use or failure to use such options or elections does not result in a payment in excess of the taxpayer's liability for foreign tax. An interpretation or application of foreign law is not reasonable if there is actual notice or constructive notice (e.g., a published court decision) to the taxpayer that the interpretation or application is likely to be erroneous. In interpreting foreign tax law, a taxpayer may generally rely on advice obtained in good faith from competent foreign tax advisors to whom the taxpayer has disclosed the relevant facts. A remedy is effective and practical only if the cost thereof (including the risk of offsetting or additional tax liability) is reasonable in light of the amount at issue and the likelihood of

success. A settlement by a taxpayer of two or more issues will be evaluated on an overall basis, not on an issue-by-issue basis, in determining whether an amount is a compulsory amount. A taxpayer is not required to alter its form of doing business, its business conduct, or the form of any business transaction in order to reduce its liability under foreign law for tax.

(ii) Examples. The provisions of paragraph (e)(5)(i) of this section may be illustrated by the following examples:

Example 1. A, a corporation organized and doing business solely in the United States, owns all of the stock of B, a corporation organized in country X. In 1984 A buys merchandise from unrelated persons for $1,000,000, shortly thereafter resells that merchandise to B for $600,000, and B later in 1984 resells the merchandise to unrelated persons for $1,200,000. Under the country X income tax, which is an income tax within the meaning of paragraph (a)(1) of this section, all corporations organized in country X are subject to a tax equal to 3 percent of their net income. In computing its 1984 country X income tax liability B reports $600,000 ($1,200,000–$600,000) of profit from the purchase and resale of the merchandise referred to above. The country X income tax law requires that transactions between related persons be reported at arm's length prices, and a reasonable interpretation of this requirement, as it has been applied in country X, would consider B's arm's length purchase price of the merchandise purchased from A to be $1,050,000. When it computes its country X tax liability B is aware that $600,000 is

not an arm's length price (by country X standards). B's knowing use of a non-arm's length price (by country X standards) of $600,000, instead of a price of $1,050,000 (an arm's length price under country X's law), is not consistent with a reasonable interpretation and application of the law of country X, determined in such a way as to reduce over time B's reasonably expected liability for country X income tax. Accordingly, $13,500 (3 percent of $450,000 ($1,050,000–$600,000)), the amount of country X income tax paid by B to country X that is attributable to the purchase of the merchandise from B's parent at less than an arm's length price, is in excess of the amount of B's liability for country X tax, and thus is not an amount of tax.

Example 2. A, a corporation organized and doing business solely in the United States, owns all of the stock of B, a corporation organized in country X. Country X has in force an income tax treaty with the United States. The treaty provides that the profits of related persons shall be determined as if the persons were not related. A and B deal extensively with each other. A and B, with respect to a series of transactions involving both of them, treat A as having $300,000 of income and B as having $700,000 of income for purposes of A's United States income tax and B's country X income tax, respectively. B has no actual or constructive notice that its treatment of these transactions under country X law is likely to be erroneous. Subsequently, the Internal Revenue Service reallocates $200,000 of this income from B to A under the authority of section 482 and the treaty. This reallocation constitutes actual notice to A and constructive notice to B that B's interpretation and

application of country X's law and the tax treaty is likely to be erroneous. B does not exhaust all effective and practical remedies to obtain a refund of the amount of country X income tax paid by B to country X that is attributable to the reallocated $200,000 of income. This amount is in excess of the amount of B's liability for country X tax and thus is not an amount of tax.

Example 3. The facts are the same as in example 2, except that B files a claim for refund (an administrative proceeding) of country X tax and A or B invokes the competent authority procedures of the treaty, the cost of which is reasonable in view of the amount at issue and the likelihood of success. Nevertheless, B does not obtain any refund of country X tax. The cost of pursuing any judicial remedy in country X would be unreasonable in light of the amount at issue and the likelihood of B's success, and B does not pursue any such remedy. The entire amount paid by B to country X is a compulsory payment and thus is an amount of tax paid by B.

Example 4. The facts are the same as in example 2, except that, when the Internal Revenue Service makes the reallocation, the country X statute of limitations on refunds has expired; and neither the internal law of country X nor the treaty authorizes the country X tax authorities to pay a refund that is barred by the statute of limitations. B does not file a claim for refund, and neither A nor B invokes the competent authority procedures of the treaty. Because the country X tax authorities would be barred by the statute of limitations from paying a refund, B has no effective and practicable remedies.

The entire amount paid by B to country X is a compulsory payment and thus is an amount of tax paid by B.

Example 5. A is a U.S. person doing business in country X. In computing its income tax liability to country X, A is permitted, at its election, to recover the cost of machinery used in its business either by deducting that cost in the year of acquisition or by depreciating that cost on the straight line method over a period of 2, 4, 6 or 10 years. A elects to depreciate machinery over 10 years. This election merely shifts A's tax liability to different years (compared to the timing of A's tax liability under a different depreciation period); it does not result in a payment in excess of the amount of A's liability for country X income tax in any year since the amount of country X tax paid by A is consistent with a reasonable interpretation of country X law in such a way as to reduce over time A's reasonably expected liability for country X tax. Because the standard of paragraph (e)(5)(i) of this section refers to A's reasonably expected liability, not its actual liability, events actually occurring in subsequent years (e.g., whether A has sufficient profit in such years so that such depreciation deductions actually reduce A's country X tax liability or whether the country X tax rates change) are immaterial.

Example 6. The internal law of country X imposes a 25 percent tax on the gross amount of interest from sources in country X that is received by a nonresident of country X. Country X law imposes the tax on the nonresident recipient and requires any resident of country X that pays such interest to a nonresident to

withhold and pay over to country X 25 percent of such interest, which is applied to offset the recipient's liability for the 25 percent tax. A tax treaty between the United States and country X overrides internal law of country X and provides that country X may not tax interest received by a resident of the United States from a resident of country X at a rate in excess of 10 percent of the gross amount of such interest. A resident of the United States may claim the benefit of the treaty only by applying for a refund of the excess withheld amount (15 percent of the gross amount of interest income) after the end of the taxable year. A, a resident of the United States, receives a gross amount of 100u (units of country X currency) of interest income from a resident of country X from sources in country X in the taxable year 1984, from which 25u of country X tax is withheld. A does not file a timely claim for refund. 15u of the amount withheld (25u–10u) is not a compulsory payment and hence is not an amount of tax.

(iii) [Reserved]

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(f) Taxpayer—(1) In general. The person by whom tax is considered paid for purposes of sections 901 and 903 is the person on whom foreign law imposes legal liability for such tax, even if another person (e.g., a withholding agent) remits such tax. For purposes of this section, § 1.901–2A and § 1.903–1, the person on whom foreign law imposes such liability is referred to as the "taxpayer." A foreign tax of a type described in paragraph (a)(2)(ii)(C) of this section is considered to be imposed on the recipients of wages if such tax is

deducted from such wages under provisions that are comparable to section 3102(a) and (b) of the Internal Revenue Code.

(2) Party undertaking tax obligation as part of transaction—(i) In general. Tax is considered paid by the taxpayer even if another party to a direct or indirect transaction with the taxpayer agrees, as a part of the transaction, to assume the taxpayer's foreign tax liability. The rules of the foregoing sentence apply notwithstanding anything to the contrary in paragraph (e)(3) of this section. See § 1.901–2A for additional rules regarding dual capacity taxpayers.

(ii) Examples. The provisions of paragraphs (f)(1) and (2)(i) of this section may be illustrated by the following examples:

Example 1. Under a loan agreement between A, a resident of country X, and B, a United States person, A agrees to pay B a certain amount of interest net of any tax that country X may impose on B with respect to its interest income. Country X imposes a 10 percent tax on the gross amount of interest income received by nonresidents of country X from sources in country X, and it is established that this tax is a tax in lieu of an income tax within the meaning of § 1.903–1(a). Under the law of country X this tax is imposed on the nonresident recipient, and any resident of country X that pays such interest to a nonresident is required to withhold and pay over to country X 10 percent of the amount of such interest, which is applied to offset the recipient's liability for the tax. Because legal liability

for the tax is imposed on the recipient of such interest income, B is the taxpayer with respect to the country X tax imposed on B's interest income from B's loan to A. Accordingly, B's interest income for federal income tax purposes includes the amount of country X tax that is imposed on B with respect to such interest income and that is paid on B's behalf by A pursuant to the loan agreement, and, under paragraph (f)(2)(i) of this section, such tax is considered for purposes of section 903 to be paid by B.

Example 2. The facts are the same as in example 1, except that in collecting and receiving the interest B is acting as a nominee for, or agent of, C, who is a United States person. Because C (not B) is the beneficial owner of the interest, legal liability for the tax is imposed on C, not B (C's nominee or agent). Thus, C is the taxpayer with respect to the country X tax imposed on C's interest income from C's loan to A. Accordingly, C's interest income for federal income tax purposes includes the amount of country X tax that is imposed on C with respect to such interest income and that is paid on C's behalf by A pursuant to the loan agreement. Under paragraph (f)(2)(i) of this section, such tax is considered for purposes of section 903 to be paid by C. No such tax is considered paid by B.

Example 3. Country X imposes a tax called the "country X income tax." A, a United States person engaged in construction activities in country X, is subject to that tax. Country X has contracted with A for A to construct a naval base. A is a dual capacity taxpayer (as defined in paragraph (a)(2)(ii)(A) of this section) and, in accordance with paragraphs (a)(1)

and (c)(1) of § 1.901–2A, A has established that the country X income tax as applied to dual capacity persons and the country X income tax as applied to persons other than dual capacity persons together constitute a single levy. A has also established that that levy is an income tax within the meaning of paragraph (a)(1) of this section. Pursuant to the terms of the contract, country X has agreed to assume any country X tax liability that A may incur with respect to A's income from the contract. For federal income tax purposes, A's income from the contract includes the amount of tax liability that is imposed by country X on A with respect to its income from the contract and that is assumed by country X; and for purposes of section 901 the amount of such tax liability assumed by country X is considered to be paid by A. By reason of paragraph (f)(2)(i) of this section, country X is not considered to provide a subsidy, within the meaning of paragraph (e)(3) of this section, to A.