No. 16-1130

In the Supreme Court of the United States

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

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

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QUESTION PRESENTED

Whether the economic substance of a transaction for which a taxpayer claims foreign tax credits on its federal tax return depends in part on whether the transaction was profitable after all foreign taxes were paid.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-23a) is reported at 844 F.3d 15. The opinions of the district court (Pet. App. 24a-40a, 41a-60a) are reported at 977 F. Supp. 2d 46 and 144 F. Supp. 3d 239.

JURISDICTION

The judgment of the court of appeals was entered on December 16, 2016. The petition for a writ of certiorari was filed on March 16, 2017. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. The United States taxes income earned abroad by U.S. citizens, residents, and domestic entities. 26 U.S.C. 61(a). Accordingly, when calculating its income for U.S. tax purposes, a U.S. corporation must include income earned abroad, even though that income may

also be subject to foreign tax. Domestic taxpayers, however, may claim a dollar-for-dollar tax credit (called the "foreign tax credit") for income taxes paid to another country, subject to numerous rules and other limitations. 26 U.S.C. 901-909. That credit serves to reduce barriers to engaging in "legitimate business transactions" abroad, Pet. App. 23a, by "avoiding double taxation," *id.* at 20a.

Like other provisions of the Internal Revenue Code, foreign tax credits are subject to the "economic substance" doctrine. Pet. App. 10a-12a & n.7. Under that longstanding common-law principle, which was codified by Congress in 2010, "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). The doctrine reflects the principle that Congress does not intend for sham transactions to produce tax benefits, even if the transactions would otherwise trigger tax benefits under the pertinent statutory and regulatory provisions. See H.R. Rep. No. 443, 111th Cong., 2d Sess. 295 (2010); see also 12 *Mertens Law of Federal Income Taxation* § 45D:62, at 220 (Supp. 2017) ("Entitlement to foreign tax credits is predicated on a valid transaction.").

2. Petitioner is a financial-services company that used a tax strategy called Structured Trust Advantaged Repackaged Securities (STARS) to generate more than $400 million in foreign tax credits. Pet. App. 1a-2a; C.A. App. 79. The shelter was developed and promoted to several U.S. banks by Barclays Bank PLC, a U.K. financial-services company, and the accounting firm KPMG, LLC. Pet. App. 3a-4a, 26a. The Internal Revenue Service (IRS) ultimately concluded

that the STARS transaction was a sham, and that the economic-substance doctrine therefore prohibited petitioner from claiming the foreign tax credits. *Id.* at 2a; C.A. App. 38-40.

a. A taxpayer ordinarily would have no economic incentive to engage in a transaction solely to claim foreign tax credits because the credits are designed to create an economic wash in which each dollar of foreign tax paid offsets one dollar of U.S. tax owed. STARS, however, was designed to transform the foreign tax credit into economic profit, at the expense of the U.S. Treasury. STARS involved an arrangement whereby the U.S. taxpayer paid tax to the United Kingdom, claimed a foreign tax credit for that U.K. tax, and simultaneously recouped a substantial portion of its U.K. tax. Pet. App. 7a-10a; C.A. App. 1022. Instead of the typical one-to-one correlation of credits claimed to taxes paid, the taxpayer thus received one dollar in U.S. tax credits for substantially less than one dollar in foreign taxes paid.

The STARS shelter was extremely complex, but in general terms it worked as follows. The U.S. taxpayer diverted income from U.S. assets (such as loans to U.S. borrowers) into and out of a wholly owned Delaware trust that had a nominal U.K. trustee. Pet. App. 7a-10a. Circulation of the income through the trust was purely a paper transaction, and no income was put at risk or deployed in any productive activities. *Id.* at 8a-9a, 14a n.10, 21a-23a; C.A. App. 666-673, 2146-2165, 2174-2185, 2188-2195, 2203-2215, 2224-2225. Because the trustee was a U.K. resident, however, circulation of the income through the trust caused the income to become subject to U.K. tax, even though the assets and income never left the United States or the U.S.

taxpayer's control. Pet. App. 7a-10a, 22a; C.A. App. 2175, 2226-2227, 2539-2566. The taxpayer would pay the trust's U.K. tax and claim corresponding foreign tax credits on its U.S. return. Pet. App. 7a, 9a-10a.

STARS, however, incorporated a mechanism that allowed the taxpayer to recoup a substantial portion of the U.K. tax, while retaining the full amount of the U.S. foreign tax credits. Barclays, the entity that marketed STARS, acquired at the outset a formal interest in the Delaware trust. Pet. App. 7a-8a. Under U.K. law, that formal interest allowed Barclays to claim certain U.K. tax benefits, ultimately permitting Barclays to recover almost the full amount (in this case, 85%) of the taxes that the taxpayer had paid. *Id.* at 8a-10a. As part of the STARS strategy, Barclays agreed to return a significant percentage of that amount to the U.S. taxpayer, while keeping the rest as its fee. *Id.* at 9a-10a; C.A. App. 72-73, 2156.

As a result, the U.S. taxpayer would receive an effective refund (through Barclays) of approximately 50% of its U.K. taxes, while claiming a foreign tax credit on its U.S. tax return as if it had paid 100% of those taxes. Pet. App. 9a; C.A. App. 1022, 2155-2156, 2215-2216. That benefit was achieved without putting any money at economic risk and without engaging in any productive business activities. Pet. App. 8a-9a, 14a n.10, 21a-23a. The STARS strategy had an unlimited capacity to generate additional foreign tax credits, bounded only by the amount of income that a taxpayer could cycle through the trust and the taxpayer's apprehension about arousing the suspicions of tax authorities. *Id.* at 7a, 21a-23a.[1]

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[1] By way of illustration, assume that a U.S. taxpayer circulates its U.S. income through a STARS trust, which pays the United

b. After learning about the STARS tax shelter from Barclays and KPMG, petitioner employed the transaction to generate more than $400 million in foreign tax credits during the 2003-2007 tax years. Pet. App. 1a-2a; C.A. App. 79. Barclays informed petitioner that "[t]he benefit under STARS arises from the ability of both [Barclays and petitioner] to obtain credits for the taxes paid in the trust" and then share those tax credits. C.A. App. 2237. Petitioner further understood that the "benefit * * * is being funded by the US Treasury" because STARS "tak[es] money that was previously being paid to the US Treasury [and] redirect[s] it to the UK Treasury," which "effectively rebat[es] most of it to Barclays, who then rebates part of the funds back to [petitioner]." *Id.* at 1022. Petitioner also understood that "[w]ithout the UK tax liability" the STARS transaction was "not worth doing." *Id.* at 1130.

In petitioner's version of the scheme, the payments from Barclays were called Bx payments, and they equaled 50% of the U.K. taxes on the income that

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Kingdom $22 in tax for every $100 of trust income. Pet. App. 9a-10a. For every $22 paid in U.K. tax, the U.S. taxpayer claims a corresponding foreign tax credit, thereby reducing its U.S. tax liability by $22. *Ibid.* At the same time, Barclays recovers $18.70 from the United Kingdom as a result of the tax benefits generated by STARS, leaving the United Kingdom with $3.30. Pet. App. 10a; C.A. App. 2155-2156. Under the STARS agreement, Barclays splits the tax benefits with the U.S. taxpayer by returning $11 to the U.S. taxpayer, Pet. App. 10a, and keeping the rest as its fee, C.A. App. 72-73, 2156. The reduction of U.S. taxes resulting from foreign tax credits thus primarily funds the STARS benefits received by the U.S. taxpayer and Barclays, with only a small portion going to the U.K. Treasury, all at the expense of the U.S. Treasury. Pet. App. 10a; C.A. App. 1022, 2154-2158, 2194-2197, 2216-2219.

petitioner cycled through the Delaware trust. Pet. App. 9a. Petitioner described the Bx payments as "rebates." C.A. App. 1022. Barclays acquired an interest in the trust for $1.15 billion, which petitioner treated as a "loan" in light of petitioner's obligation to repurchase that trust interest for $1.15 billion. Pet. App. 7a-8a. The "loan" could be terminated by either Barclays or petitioner at any time and was not necessary for generating the foreign tax credits; indeed, as originally designed, STARS did not include the loan component. *Id.* at 8a n.6. Because the Bx payments that Barclays owed petitioner were used to offset the interest that petitioner owed Barclays on the loan, the loan served to mask the fact that the Bx payments were effectively rebates of petitioner's U.K. taxes. *Id.* at 9a; C.A. App. 1022, 1027.

The loan also gave the transaction a patina of a legitimate business purpose even though, absent the Bx payments' offset, the loan's interest rate was far higher than the interest rate of petitioner's available alternative funding. C.A. App. 1121, 2180, 2193-2194, 2416. In marketing STARS to petitioner, the promoters suggested that petitioner could identify "low-cost funding" as the "business purpose" for STARS. *Id.* at 2443, 2544. In its own analysis of STARS, however, petitioner recognized that its actual expense for interest on the loan was separate from the effective rebate of its U.K. taxes that it would receive from Barclays. *Id.* at 139, 241, 256. Petitioner further understood that the Bx payment had no relationship to the amount of the loan, but instead was based exclusively on the amount of tax that the trust was expected to

pay to the United Kingdom. *Id.* at 1202, 1706-1707 & n.14, 2039.[2]

c. In 2005, U.K. tax authorities "called STARS transactions to the attention of the IRS as a potential impermissible tax shelter." Pet. App. 20a. In 2007, the Treasury Department proposed regulations (which were finalized in 2011) that precluded taxpayers from claiming foreign tax credits from STARS and similar transactions after the regulations' effective date. See 72 Fed. Reg. 15,081 (Mar. 30, 2007) (proposed regulations); 76 Fed. Reg. 42,038 (July 18, 2011) (final regulations); see also Pet. App. 2a-3a. The proposed regulations' preamble indicated that the IRS would scrutinize tax benefits claimed in STARS transactions conducted before the regulations' effective date under various anti-abuse doctrines, including the economic-substance doctrine. 72 Fed. Reg. at 15,084. Although petitioner had planned to participate in the STARS scheme for five years, it terminated its participation "early, in July 2007, when STARS and similar transactions became the subject of heightened scrutiny from the IRS." Pet. App. 2a.

3. In its corporate tax returns for the years in which it had participated in STARS, petitioner claimed

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[2] The amount of the Bx rebate payments was set at 50% of the tax that petitioner expected to pay to the United Kingdom, Pet. App. 9a, and therefore would have been the same whether the amount of the loan was $1, $100 billion, or something in between. Indeed, the artificial embedding of the Bx rebate payments in the loan generated an economically irrational negative bank-loan interest rate, whereby Barclays purportedly paid petitioner to borrow Barclays' funds. C.A. App. 290, 692, 794, 1293, 2039. Petitioner had hoped, for tax purposes, to avoid a negative interest rate because such a rate belied its characterization of the STARS transaction as a loan. *Id.* at 794, 1712.

the full amount (approximately $400 million) of foreign tax credits that the strategy was designed to produce.[3] The IRS disallowed petitioner's tax treatment of STARS on various grounds, including that the transaction lacked economic substance and had no valid business purpose. C.A. App. 38-40. The IRS therefore denied the claimed tax benefits and imposed accuracy-related penalties for the resulting tax underpayments. *Ibid.* Petitioner then filed this refund suit in district court. Pet. App. 2a.

As relevant here, the district court concluded that petitioner had properly claimed the foreign tax credit, and the court granted petitioner's motion for summary judgment on that issue. Pet. App. 41a-60a. The court held that the STARS trust transaction had economic substance because it provided petitioner a reasonable prospect of profit. *Id.* at 45a-49a. The court observed that it had previously determined that the Bx payments should be counted in assessing profit because the payments constituted income rather than a tax rebate. *Id.* at 45a; see *id.* at 24a-40a. The court further declined to treat petitioner's U.K. tax payments as a cost of obtaining the Bx payments, which would make the transaction profitless because petitioner was required to pay $2 of U.K. tax for every $1 it received in Bx payments. *Id.* at 45a-49a. The court acknowledged that its resolution of the economic-substance issue conflicted with the decisions of the two courts of appeals that had considered that question. See *id.* at 48a n.4, 49a; see also *Bank of N.Y. Mellon Corp.* v. *Commissioner*, 801 F.3d 104 (2d Cir.

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[3] This case involves only the 2003-2005 tax years, Pet. App. 2a, but the subsequent years will be governed by the decision here as well.

2015), cert. denied, 136 S. Ct. 1375, and 136 S. Ct. 1377 (2016); *Salem Fin., Inc.* v. *United States*, 786 F.3d 932 (Fed. Cir. 2015), cert. denied, 136 S. Ct. 1366 (2016).

4. The court of appeals reversed in relevant part, holding that petitioner could not claim foreign tax credits based on the STARS transaction because the trust component lacked economic substance. Pet. App. 1a-23a.

The court of appeals observed that the economic-substance doctrine is "a tool of statutory interpretation," Pet. App. 11a, that is "centered on discerning whether the challenged transaction objectively 'lies outside the plain intent of the [relevant statutory regime],'" *id.* at 14a (brackets in original) (quoting *Gregory* v. *Helvering*, 293 U.S. 465, 470 (1935)). The court explained that, "when a transaction 'is one designed to produce tax gains . . . [not] real gains,' * * * —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." *Id.* at 15a (brackets in original) (quoting *Dewees* v. *Commissioner*, 870 F.2d 21, 31 (1st Cir. 1989) (Breyer, J.)). The court further observed that its analysis was consistent with Congress's codification of the economic-substance test because "Congress specified that the 2010 codification would be applied as courts have previously and consistently applied the economic substance doctrine." *Id.* at 11a n.9.

The court of appeals then examined the "economic reality" of the STARS shelter. Pet. App. 16a (citation omitted). The court "conclude[d] both that the

STARS Trust transaction had no objective non-tax economic benefit and that Congress, in creating the foreign tax credit regime, did not intend that it would cover this type of generated transaction." *Id.* at 17a-18a. The court found that "the Trust transaction is shaped solely by tax-avoidance features * * * that lack a bona fide business purpose." *Id.* at 16a (citation and internal quotation marks omitted).

The court of appeals noted that petitioner'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." Pet. App. 22a. The court concluded that, "whether the Bx payment is best characterized as a rebate or as income," the STARS trust "transaction is profitless because the 'profit' to [petitioner] from the Bx payment c[ame] at the expense of exposure to double the Bx payment's value in U.K. taxes." *Id.* at 16a. The court further observed that, "unlike long-term investments that may not initially turn a profit, but which have economic substance, the Trust transaction lack[ed] any real economic risk." *Id.* at 21a. The court explained that "[t]he assets in the Trust never effectively left [petitioner'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." *Id.* at 22a. The court accordingly concluded that "[t]he Trust transaction was not a legitimate business and lacked economic substance." *Id.* at 23a.

ARGUMENT

The court of appeals correctly held that the STARS trust transaction lacked economic substance, and that petitioner therefore could not lawfully claim foreign

tax credits based on that transaction, because petitioner did not engage in any productive business activities and lacked a business purpose. The court's decision does not conflict with any decision of this Court or another court of appeals. In light of Congress's 2010 codification of the economic-substance doctrine, which specifically addresses the treatment of foreign taxes, the question whether petitioner could properly claim tax credits under pre-2010 law also lacks prospective importance. Last Term, this Court denied two certiorari petitions raising substantially the same issue, and there is no reason for a different result here. See *Bank of N.Y. Mellon Corp.* v. *Commissioner*, 136 S. Ct. 1377 (2016) (No. 15-572); *Salem Fin., Inc.* v. *United States*, cert. denied, 136 S. Ct. 1366 (2016) (No. 15-380). Further review is not warranted.

1. The court of appeals correctly held that the STARS trust lacked economic substance and that petitioner therefore was not entitled to the tax benefits that the shelter was designed to produce. See Pet. App. 15a-23a.[4]

a. The court of appeals concluded that the STARS trust transaction did not have a bona fide business purpose and did not involve genuine business activi-

[4] If this Court grants review, the government may also renew two arguments that the district court rejected and the court of appeals did not reach: (i) that the Bx payments should not be classified as income for purposes of the economic-substance analysis; and (ii) that the trust transaction should be recharacterized under the substance-over-form doctrine. See *Smith* v. *Phillips*, 455 U.S. 209, 215 n.6 (1982) (observing that a respondent "may, of course, defend the judgment below on any ground which the law and the record permit, provided the asserted ground would not expand the relief which has been granted").

ties. Pet. App. 16a-23a. The court found that the scheme had no meaningful impact on petitioner's business interests other than to "artificially generate[]" a U.K. tax obligation "through a series of circular cash flows" for the sole purpose of creating tax credits for foreign tax that, in substance, was not paid. *Id.* at 22a. The court based that determination on several facts, including that the STARS trust transaction (i) "was a 'prepackaged strategy' created to generate" foreign tax credits, *id.* at 19a (quoting *Salem Fin., Inc.* v. *United States*, 786 F.3d 932, 952 (Fed. Cir. 2015), cert. denied, 136 S. Ct. 1366 (2016)); (ii) "d[id] not have a reasonable prospect of creating a profit without considering the foreign tax credits," *id.* at 16a; (iii) "posed no non-tax risks to [petitioner]," *id.* at 21a; (iv) had no impact on the U.S. assets that petitioner placed in the trust, which "never effectively left [petitioner's] control" and which did not "perform any function when placed in the Trust that they could not without the Trust," *id.* at 22a; (v) "provided no business for [petitioner]," *id.* at 23a; and (vi) was "shaped solely by tax-avoidance features" that "lack a bona fide business purpose," *id.* at 16a (quoting *Salem Fin.*, 786 F.3d at 942, 948).

"Congress, in creating the foreign tax credit regime, did not intend that it would cover" transactions like the STARS scheme, which "had no objective non-tax economic benefit." Pet. App. 17a-18a. Petitioner used the STARS shelter to claim foreign tax credits as if it had paid the full amount of foreign tax, even though it had recouped approximately half of its foreign-tax payments through the Bx payments. *Id.* at 9a; C.A. App. 1022. The amount of those payments bore no relation to the amount of the loan that peti-

tioner had employed to give STARS a veneer of a legitimate purpose. C.A. App. 1027. Rather, the Bx payments correlated directly with the amount of foreign tax that petitioner paid, enabling petitioner to claim approximately $2 in foreign tax credits for every $1 of out-of-pocket cost.

b. Petitioner's objections to the court of appeals' economic-substance analysis lack merit.

i. Petitioner contends (Pet. 3-4, 13-17) that the court of appeals erred in invoking, as one consideration supporting its conclusion that the shelter was a sham, the fact that the STARS trust did not offer a reasonable opportunity for economic profit after foreign tax was paid. That argument ignores the function of the economic-substance doctrine to distinguish legitimate business transactions from transactions that are "shaped solely by tax-avoidance features that have meaningless labels attached." *Frank Lyon Co.* v. *United States*, 435 U.S. 561, 584 (1978). To identify transactions that lack economic substance, courts generally ask whether the transaction is "one designed to produce tax gains" rather than "real gains." Pet. App. 15a (quoting *Dewees* v. *Commissioner*, 870 F.2d 21, 31 (1st Cir. 1989) (Breyer, J.)). The court of appeals thus correctly considered whether the STARS trust transaction had "profit potential, independent of the expected tax benefits." *Id.* at 16a (quoting *Salem Fin.*, 786 F.3d at 948).

In the context of the STARS trust transaction, that inquiry appropriately focused on whether the transaction was profitable after foreign tax was paid. Because the "artificial[] generat[ion]" of a U.K. tax obligation "was the quid pro quo for the Bx payment," the foreign tax expense was a direct cost of obtaining the

only payment generated by the STARS trust. Pet. App. 22a. More generally, where foreign taxes and other costs of a taxpayer's putative foreign business overwhelm any potential for profit, that imbalance raises a serious concern that the transaction may be a sham. Legitimate, profit-seeking business transactions rarely involve activities where costs, inclusive of taxes, subsume any profit potential.

Contrary to petitioner's suggestion (Pet. 13, 35), however, the court of appeals did not hold that the absence of post-foreign-tax profitability is *determinative* of the economic-substance question. See Pet. App. 20a-21a. Rather, the court explicitly adopted the approach of the Federal Circuit in *Salem Financial*. See *id.* at 16a, 20a-21a. Under that approach, the fact that "a taxpayer has incurred a large foreign tax expense that would render the transaction unprofitable absent the foreign tax credit" triggers "careful review of the transaction" to determine whether it "meaningfully alters the taxpayer's economic position (other than with regard to the tax consequences) and whether the transaction has a bona fide business purpose." *Salem Fin.*, 786 F.3d at 950; see Pet. App. 16a-21a. To be sure, "some transactions that are not immediately profitable without tax benefits, such as investments in 'nascent technologies,' may have economic substance." Pet. App. 20a-21a (quoting *Salem Fin.*, 786 F.3d at 950). But the court of appeals properly accounted for that possibility by treating post-foreign-tax profitability as an important but not dispositive factor in its economic-substance analysis. That contextual, transaction-specific analysis reflects a sound application of economic-substance principles.

ii. Petitioner also contends (Pet. 2-3, 26-31) that it was entitled to foreign tax credits because the STARS trust transaction facially conformed to the applicable statutory and regulatory provisions for claiming those credits. That argument is contrary to this Court's longstanding application of the economic-substance doctrine, which reflects the premise that Congress did not intend for sham transactions to produce tax benefits *even if* the transactions technically comply with the statutory and regulatory provisions that authorize such benefits. See *Knetsch* v. *United States*, 364 U.S. 361, 365-366 (1960); *Gregory* v. *Helvering*, 293 U.S. 465, 467-470 (1935); see also *Frank Lyon*, 435 U.S. at 583-584.[5]

In its foundational economic-substance decision in *Gregory*, the Court disregarded a transaction that was "conducted according to the terms of" the relevant statutory provision. 293 U.S. at 470. The taxpayer in *Gregory* had created a corporation for the sole purpose of transferring valuable stock to herself at the capital-gains tax rate, rather than at the higher ordinary-income tax rate. *Id.* at 467. This Court disregarded the corporation for purposes of compu-

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[5] The courts of appeals likewise consistently have applied the economic-substance doctrine to reject tax shelters that technically complied with applicable tax rules but lacked economic substance. *E.g.*, *WFC Holdings Corp.* v. *United States*, 728 F.3d 736, 742-743 (8th Cir. 2013), cert. denied, 134 S. Ct. 2724 (2014); *Sala* v. *United States*, 613 F.3d 1249, 1253-1254 (10th Cir. 2010), cert. denied, 565 U.S. 814 (2011); *Dow Chem. Co.* v. *United States*, 435 F.3d 594, 599 (6th Cir. 2006), cert. denied, 549 U.S. 1205 (2007); *Winn-Dixie Stores, Inc. & Subsidiaries* v. *Commissioner*, 254 F.3d 1313, 1315-1316 (11th Cir. 2001) (per curiam), cert. denied, 535 U.S. 986 (2002); *ACM P'ship* v. *Commissioner*, 157 F.3d 231, 245-246 (3d Cir. 1998), cert. denied, 526 U.S. 1017 (1999).

ting her tax, holding that, although there was "[n]o doubt" that "a new and valid corporation was created," it "was nothing more than a contrivance" designed to transfer property at a reduced tax rate. *Id.* at 469. Permitting the taxpayer to attain tax benefits in that situation, the Court held, would "exalt artifice above reality and * * * deprive the statutory provision in question of all serious purpose." *Id.* at 470. Similarly in *Knetsch*, the Court disallowed interest-expense deductions generated by a transaction that, in form, fully complied with the relevant law. 364 U.S. at 365-366. The Court explained that a claimed tax benefit may be disallowed, even if the transaction complied with the technical tax rules, if "there was nothing of substance to be realized by [the taxpayer] from th[e] transaction beyond a tax deduction." *Id.* at 366.

Petitioner is also wrong in suggesting (Pet. 28-30) that Congress's enactment of the foreign-tax-credit regime reflects approval of contrivances like the STARS trust transaction. Congress intended for the credit to apply when a taxpayer is engaged in "legitimate business transactions," in order "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." Pet. App. 23a (quoting H.R. Rep. 1337, 83d Cong., 2d Sess. 76 (1954)) (emphasis added by court of appeals). In approving foreign tax credits, Congress could not have "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." *Id.* at 18a n.12 (quoting John P. Steines, Jr., *Subsidized Foreign Tax Credits and the Economic Substance Doctrine*, 70 Tax Law. 443, 494-495 (2017)).

iii. Finally, there is no merit to petitioner's contention (Pet. 3) that the court of appeals' decision impermissibly subjects it to "double taxation." The foreign tax credit alleviates the tax burden on entities that engage in genuine business activities abroad and would otherwise face tax obligations both in the foreign country and in the United States. Pet. App. 23a. The court of appeals found, however, that petitioner did not conduct any "legitimate business" abroad, *ibid.*, and that "[e]xposure to U.K. taxation for the purpose of generating U.S. foreign tax credits was the Trust transaction's whole function," *id.* at 18a. "[F]ar from risking double taxation," taxpayers who purchased the STARS shelter "used an extremely convoluted transaction structure" in an attempt "to take maximum advantage of U.S. and U.K. tax benefits." *Bank of N.Y. Mellon Corp.* v. *Commissioner*, 801 F.3d 104, 122 (2d Cir. 2015) (*BNY*), cert. denied, 136 S. Ct. 1375, and 136 S. Ct. 1377 (2016). The court of appeals correctly rejected that attempt.

2. Petitioner asserts (Pet. 13-31) that the decision below implicates disagreement among the circuits on the treatment of foreign taxes under the economic-substance test and the "underlying premises" of that test. Pet. 17. There is no circuit conflict that warrants this Court's review.

a. Every court of appeals to have considered the STARS shelter has held that it lacks economic substance. See *BNY*, 801 F.3d at 121-123; *Salem Fin.*,

786 F.3d at 946-951; Pet. App. 23a. Petitioner contends (Pet. 13-17) that these decisions conflict with the decisions in *Compaq Computer Corp. & Subsidiaries* v. *Commissioner*, 277 F.3d 778 (5th Cir. 2001) (*Compaq*), and *IES Industries, Inc.* v. *United States*, 253 F.3d 350 (8th Cir. 2001) (*IES*). Those decisions, however, concerned a materially different transaction and do not squarely conflict with the decisions holding that STARS trust transactions are ineligible for foreign tax credits.

In *Compaq*, the U.S. taxpayer had purchased stock of publicly traded foreign corporations before a dividend record date. 277 F.3d at 779. The price of the stock reflected the impending dividends, minus the amount of the foreign taxes that would be withheld on those dividends. *Id.* at 779-780. The taxpayer then immediately sold the stock back to the original seller, effective after the record date, at a reduced price to reflect the fact that the original seller would not be entitled to dividends. *Id.* at 780. The taxpayer received the dividends minus the withheld foreign taxes. *Ibid.* On its U.S. tax return, the taxpayer reported capital losses and the dividend income, and claimed a foreign tax credit for the taxes that the foreign corporations had withheld from the dividends. *Ibid.* The Tax Court found that the dividend payment (as reduced by the withholding) was less than the loss on the sale, so that the transaction was not economically profitable before the U.S. tax benefits were claimed. *Id.* at 782. It therefore disallowed those benefits. *Id.* at 780.

The Fifth Circuit reversed, stating that "[t]o be consistent, the analysis should either count all tax law effects or not count any of them." *Compaq*, 277 F.3d

at 785. The court explained that, "[i]f the effects of the transaction are computed consistently," the taxpayer had "made both a pre-tax profit and an after-tax profit from the * * * transaction." *Id.* at 786. The Fifth Circuit then evaluated whether the "choice to engage in the * * * transaction was solely motivated by the tax consequences of the transaction," and concluded that it was not. *Id.* at 787. "Instead," the court explained, "the evidence show[ed] that [the taxpayer] actually and legitimately also sought the (pre-tax) * * * profit it would get from the * * * dividend," and that "[a]lthough * * * the parties attempted to minimize the risks incident to the transaction, those risks did exist and were not by any means insignificant." *Ibid.* The Fifth Circuit therefore concluded that "[t]he transaction was not a mere formality or artifice but occurred in a real market subject to real risks." *Id.* at 788. The Eighth Circuit in *IES*, which considered a materially identical transaction, conducted a similar analysis and reached the same holding. See 253 F.3d at 354-356.

As the First Circuit observed in this case, *Compaq* and *IES* "did not analyze the STARS transactions" and "are distinguishable factually." Pet. App. 17a n.11. The courts in those cases allowed the claimed foreign tax credits because the relevant transactions involved "a real risk of loss and an adequate non-tax business purpose." *Compaq*, 277 F.3d at 788; see *IES*, 253 F.3d at 354-356. In this case, by contrast, the court of appeals concluded that the STARS scheme "lack[ed] any real economic risk," Pet. App. 21a, and was "shaped solely by tax-avoidance features * * * that lack a bona fide business purpose," *id.* at 16a (citation and internal quotation marks omitted).

Moreover, although the Fifth and Eighth Circuits treated post-foreign-tax profitability as irrelevant to the economic-substance analysis on the facts of those cases, neither court held that *pre*-foreign-tax profitability conclusively establishes the economic substance of the relevant transaction. Even after determining that the transactions at issue produced pre-foreign-tax profits, those courts considered other indicia of the transactions' economic effect and the taxpayers' intent. See *Compaq*, 277 F.3d at 786-787 ("[T]he evidence in the record does not show that Compaq's choice to engage in the * * * transaction was solely motivated by the tax consequences of the transaction."); *IES*, 253 F.3d at 356 ("We hold, considering all the facts and circumstances of this case, that the * * * trades in which IES engaged did not, as a matter of law, lack business purpose or economic substance."). In this case, by contrast, the court of appeals concluded that the "STARS Trust transaction had no objective non-tax economic benefit." Pet. App. 17a. There is accordingly no sound reason to believe that the Fifth and Eighth Circuits would have reached a different holding with respect to the STARS shelter than did the court below. Although the Fifth and Eighth Circuits disregarded a particular consideration (the absence of post-foreign-tax profitability) that the court of appeals here viewed as warranting close scrutiny of the transaction, their decisions do not support petitioner's contention that the STARS trust was a legitimate transaction for which it could claim foreign tax credits.

b. Petitioner also contends (Pet. 19-20) that lower courts have divided on the question whether the economic-substance test is "a judge-made common law

rule" or "a traditional tool of statutory construction." That framing sets up a false dichotomy. As the court of appeals explained, "[t]he economic substance doctrine, like other common law tax doctrines, can * * * be thought of as a tool of statutory interpretation," Pet. App. 10a-11a, implementing Congress's intent to deny tax benefits to sham transactions that "lie[] outside the plain intent of the [relevant statutory regime]," *id.* at 14a (quoting *Gregory*, 293 U.S. at 470) (second set of brackets in original); see, *e.g.*, *Salem Fin.*, 786 F.3d at 942 (observing that the economic-substance doctrine "enforce[s] the statutory purpose of the tax code") (citation omitted).

Petitioner contends (Pet. 20-21) that the Sixth and D.C. Circuits have "reject[ed] th[e] approach" of "appl[ying] the economic substance doctrine as a standalone requirement that must be satisfied independent of—and in addition to—any requirements imposed by the Internal Revenue Code." But the decisions petitioner cites do not conflict with the decisions holding that the STARS scheme lacked economic substance. In *Summa Holdings, Inc.* v. *Commissioner*, 848 F.3d 779 (2017), the Sixth Circuit declined to rely on the substance-over-form doctrine, which is a distinct anti-abuse doctrine, "to override statutory provisions whose only function is to enable tax savings." *Id.* at 789. The court emphasized that the particular Tax Code provisions at issue—involving domestic international sales corporations (DISCs) and Roth IRAs—were "designed for tax-reduction purposes." *Id.* at 786. The court further observed that "[b]y congressional design, DISCs are all form and no substance" because "[t]he Code authorizes companies to create DISCs as shell corporations that can receive com-

missions and pay dividends that have no economic substance at all." *Ibid.* The court concluded that, "[b]ecause [the taxpayer] used the DISC and Roth IRAs for their congressionally sanctioned purposes—tax avoidance—the Commissioner had no basis for recharacterizing the transactions." *Id.* at 782.

Similarly in *Horn* v. *Commissioner*, 968 F.2d 1229 (1992), the D.C. Circuit declined to apply the economic-substance doctrine to a statutory provision that the court interpreted to authorize tax benefits for particular transactions "whether or not they are economic shams." *Id.* at 1236. The court in *Horn* construed Section 108 of the Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 630, which was enacted to "clarify the law governing" a particular tax strategy that had been banned prospectively and in so doing to "eliminate the backlog of * * * cases in the Tax Court." 968 F.2d at 1232. Section 108(a) permitted a deduction for a loss from a certain type of straddle transaction "if and only if the transaction is entered into for profit or in a trade or business." *Id.* at 1238 (court's paraphrase of statutory language); see *id.* at 1233 (quoting statute). The D.C. Circuit viewed that requirement as "closely track[ing] the sham transaction doctrine." *Id.* at 1238. Section 108(b), however, "irrebuttably presume[d] that straddle trades made by commodities dealers are made in a trade or business." *Ibid.* The D.C. Circuit interpreted Section 108 as reflecting Congress's intent to permit deductions for straddle trades by commodities dealers, regardless of the profit potential of any particular trade. The court held that disregarding such trades under the economic-substance doctrine would subvert the intended treatment of a narrow class of transactions

and would "read [Section 108(b)] completely out of existence." *Id.* at 1234; see *id.* at 1236, 1238-1240.

Petitioner asserts (Pet. 25) that "the Sixth and D.C. Circuits apply a text-bound analysis, consistent with other canons of statutory construction, to discern economic substance." But the courts found that the Tax Code provisions at issue in those cases evidenced Congress's intent to authorize the particular tax benefits that were claimed. The courts accordingly concluded that anti-abuse doctrines should not be applied in a way that would subvert particularized legislative determinations. Here, by contrast, petitioner has not identified any analogous statutory provision that addresses the STARS transaction and was intended to immunize it from application of the economic-substance doctrine.

3. The questions petitioner raises about the application of the economic-substance doctrine lack prospective importance. As petitioner acknowledges (Pet. 36-37), when Congress codified the economic-substance doctrine in 2010, it specifically addressed the manner in which foreign taxes should be treated in the economic-substance analysis. Section 7701(*o*)(2)(B) directs 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). The 2010 codification also enumerates the requirements for a transaction to be deemed to have economic substance, one of which is that "the transaction changes in a meaningful way (*apart from Federal income tax effects*) the taxpayer's economic position." 26 U.S.C. 7701(*o*)(1)(A) (emphasis added). That language further supports the view that only U.S. tax consequences, not foreign-tax conse-

quences, should be excluded when determining whether a transaction has economic substance.

Thus, even if the Fifth and Eighth Circuits in *Compaq* and *IES* had held that foreign taxes should always be disregarded in determining the profit potential and ultimate economic substance of a transaction, the 2010 codification of the economic-substance doctrine would supersede those holdings for transactions entered into after March 30, 2010, the codification's effective date. Although the Secretary of the Treasury has thus far proceeded case by case rather than through regulations addressing foreign taxes, see I.R.S. Notice 2010-62, 2010-40 I.R.B. 411, 411-412, the 2010 codification makes clear that a transaction's profitability (or lack thereof) after foreign taxes are taken into account can be a relevant consideration in an economic-substance analysis. The codification thus refutes petitioner's contention that foreign taxes should never be treated as expenses in a profitability analysis, and it confirms that the question presented has no substantial ongoing importance.

The 2010 codification of the economic-substance doctrine also eliminates any need to consider whether the court of appeals erred in applying "the doctrine [as] a judge-made common law rule." Pet. 19. Although Congress intended to codify the preexisting common-law doctrine, 26 U.S.C. 7701(*o*)(5)(A), Congress's understanding of that doctrine as reflected in the 2010 codification will be highly relevant in resolving economic-substance disputes going forward. Because the transaction at issue here preceded the 2010 codification's effective date and thus would provide the Court no opportunity to apply and construe the codification, further review is not warranted. If any

conflict in authority eventually develops concerning the proper understanding of the 2010 codification, that conflict can be resolved in a future case to which the codification applies by its terms.

Petitioner asserts that the decision below creates "uncertainty" for "cross border transactions" and will impede "foreign investment abroad." Pet. 32-33 (citation omitted). But the STARS scheme did not involve any cross-border transactions or foreign investment. The funds petitioner employed in the scheme never left the United States or petitioner's control and were instead merely cycled in and out of a Delaware trust.

Petitioner incurred a U.K. tax liability not because it had engaged in a legitimate business transaction in the United Kingdom, but because it had selected a U.K. resident as the nominal trustee of its Delaware trust for the very purpose of subjecting its U.S. assets to U.K. taxation. Pet. App. 7a; C.A. App. 1121-1122, 2158-2159, 2196, 2566. Because the STARS scheme "fictionalize[d] the concept of international trade," *BNY*, 801 F.3d at 118 (internal quotation marks omitted), and "involv[ed] no commerce or bona fide business abroad," *Salem Fin.*, 786 F.3d at 954, petitioner's concern about effects on legitimate cross-border business transactions is misplaced. In any event, this Court could not effectively clarify the applicable law going forward by resolving a case, like this one, that involves a pre-2010 transaction.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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