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,

Respondent.

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

REPLY BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI

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REPLY BRIEF FOR PETITIONER

The First Circuit's decision in this case deepens a circuit split between the Fifth and Eighth Circuits, on the one hand, and the Federal and Second Circuits on the other. The First Circuit joined the Federal and Second Circuits in holding that, for purposes of determining the "pre-tax" profitability of a cross-border transaction – and, therefore, the economic substance of that transaction – courts should count foreign taxes as pre-tax transaction expenses. This conflict lays bare a broader and deeper disagreement among the circuits: whether the economic substance of a transaction depends on the meaning and purpose of the statutory and regulatory provisions at issue, or, alternatively, depends only on common-law principles divorced from the text of the Internal Revenue Code.

The Government fails to offer any justification for treating foreign tax differently from U.S. tax for purposes of determining entitlement to Foreign Tax Credits ("FTCs"). Such discrimination discourages cross-border transactions and frustrates Congress' intent in enacting FTCs. Pet. 31-33. Even the Government concedes that Congress' aim was "to produce uniformity of tax burden among United States taxpayers, irrespective of whether they are engaged" in business abroad or domestically. BIO 16 (citation omitted). The Government's rule has the opposite effect. The Government does not deny the need for certainty and predictability regarding FTCs. Pet. 31-33. This Court's review is amply warranted.

I. The First Circuit's Decision Rests On Whether Foreign Taxes Should Be Counted As Pre-Tax Expenses.

The Government contends that the First Circuit correctly held that the STARS trust lacked economic substance. BIO 11-17. But that conclusion assumes the outcome of the Question Presented. That is, if foreign taxes are treated like domestic taxes and excluded from the pre-tax profitability calculation (as Petitioner seeks), then the transaction passes muster under the pre-tax profit test, as the District Court found in this case. Pet. App. 25a, 45a-49a. A transaction with a reasonable opportunity for appreciable pre-tax profit affects the taxpayer's economic position and has economic substance as a matter of law. *Frank Lyon Co. v. United States*, 435 U.S. 561, 583-84 (1978); *Gregory v. Helvering*, 293 U.S. 465, 469 (1935).

The Government asserts that the First Circuit undertook a "contextual, transaction-specific analysis" (BIO 14) and based its determination "on several facts" regarding the STARS transaction at issue in this case. *Id.* at 12. But that assertion misses the point: the Question Presented determines the *outcome* of the factual issues cited by the Government. The First Circuit concluded that the Trust transaction was "profitless" and "shaped solely by tax-avoidance features" that "lack a bona fide business purpose" (Pet. App. 16a) (citation omitted), *precisely because* the court included foreign taxes in the pre-tax profitability calculation and found that those taxes outweighed any potential of profit by Sovereign. *Id.* at 16a-17a. As the District Court opined, to say that the Trust transaction "had little to no potential for economic return apart from the

tax payments," is "not a reason for including the tax payments" as pre-tax expenses, "but rather a conclusion about what happens *if* the payments are included." *Id.* at 49a n.6 (emphasis in original).

The Government points to the First Circuit's reference to the statement of the Federal Circuit that the pre-tax profitability test would not necessarily be dispositive in certain situations, such as "investments in 'nascent technologies.'" BIO 14 (citing Pet. App. 21a). But this caveat does not affect *this* case, which does not involve emerging technologies. Indeed, the Government omits the next sentence of the First Circuit's opinion: "But the Trust transaction is not comparable to such transactions…." Pet. App. 21.[1]

II. Review Is Necessary To Resolve The Circuit Split.

The Government argues there is no circuit conflict because *Compaq Computer Corp. v. Comm'r*, 277 F.3d 778 (5th Cir. 2001), and *IES Indus., Inc. v. Comm'r*, 253 F.3d 350 (8th Cir. 2001), are "distinguishable factually" from the decision below. BIO 18-19. But regardless of the factual contexts in

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[1] In other cases involving STARS, courts have disagreed on whether the payments from Barclays to the taxpayer were "income" or a "tax effect." *Compare Salem Financial v. Comm'r*, 786 F.3d 932, 944-45 (Fed. Cir. 2015) (payment was income to taxpayer); App. 36a (same) (District Court in this case) *with Bank of New York Mellon Corp. v. Comm'r*, 801 F.3d 104, 121-22 (2d Cir. 2015) (affirming trial court that payment was not income); *Wells Fargo & Co. v. United States*, No. 09-cv-2764, Order at 3 n.1 (May 24, 2017) (payment is a "tax benefit (and not an item of pre-tax revenue)"). The First Circuit declined to address this issue, Pet. App. 16a, and it is not presented by this Petition.

which the cases arose, the legal rules the cases apply are irreconcilable.

The Fifth and Eighth Circuits articulated a clear legal rule: foreign taxes should be treated like domestic taxes and excluded from the pre-tax profit calculation. The Fifth Circuit held "as a matter of law" that pre-tax profit is to be measured by the "gross amount" earned, before paying foreign taxes. *Compaq*, 277 F.3d at 784. The Eighth Circuit likewise held that pre-tax profit should be computed "before the foreign taxes were paid." *IES*, 253 F.3d at 354. By contrast, the First Circuit in this case "mirror[ed]" the conclusion of the Federal Circuit in *Salem Financial*, and held that Sovereign's U.K. tax payments should be "factored into the pre-tax profitability calculation," rendering "the Trust transaction . . . plainly profitless." Pet. App. 16a-17a.

Unlike the Government, the lower courts recognize the existence of a circuit split. In *Salem Financial*, the Federal Circuit – analyzing a STARS transaction – expressly disagreed with, and specifically criticized, the Fifth and Eighth Circuits for evaluating the economic substance of cross-border transactions "without taking into account the foreign taxes paid." 786 F.3d at 948. The Federal Circuit explained that had it been confronted with the transactions at issue in *Compaq* and *IES*, it would have concluded that those transactions "produced no real economic profit" and were void under the economic substance doctrine. *Id.* at 947-48. In the decision below, the First Circuit stated that it "agree[d] with the *Salem* court's analysis of this issue," Pet. App. 17a n.11, as did the Second Circuit in the *Bank of New York*, 801 F.3d at 124 (agreeing "with the Federal Circuit in *Salem* and

disagree[ing] with decisions of the Fifth and Eighth Circuits (*Compaq* and *IES*, respectively)").

The Government strains to uncover material distinctions that have eluded the appellate courts. The Government asserts that the courts in *Compaq* and *IES* concluded the transactions involved "an adequate non-tax business purpose," BIO 19 (quoting *Compaq*, 277 F.3d at 788), while the court of appeals in this case concluded the STARS transaction did not, BIO 19 (quoting App. 21a). But this is just another way of saying that the Fifth and Eighth Circuits concluded the transactions were profitable (after excluding foreign tax payments from the pre-tax profitability calculation), and the First Circuit concluded it was not (after including foreign tax payments). The distinction the Government highlights did not *cause* different outcomes among the circuits; it is the *consequence* of the circuits applying different legal rules.

The Government's effort to emphasize the Fifth and Eighth Circuits analysis of other factors, such as whether there was a risk of loss (BIO 19), mischaracterizes the holdings in *Compaq* and *IES*. The appellate courts considered these other factors "arguably relevant," *IES*, 253 F.3d at 355, apparently only because the government cited them as support for *its* argument that the transactions lacked economic substance. The Fifth and Eighth Circuits both found that the expected pre-tax profit required them to hold that the transactions had economic substance as a matter of law, *notwithstanding* the transactions' "minimal" risk. *Id.* at 355; *Compaq*, 277 F.3d at 787. The Fifth Circuit explained that Compaq's investigation of the risks "would not make a difference to the outcome of this

case." *Compaq*, 277 F.3d at 787 n.9. Thus, the government's assertion that pre-foreign tax profitability did not "conclusively establish[ ] the economic substance of the relevant transactions" in these cases is incorrect. BIO 20.

Further, any risk of loss was much greater here. *Compaq* and *IES* involved essentially no risk and no opportunity for economic gain except for the tax benefits. Those cases upheld foreign tax credits against economic-substance challenges where the taxpayers had no foreign activity but simply bought and sold foreign securities in prearranged U.S. transactions designed to minimize risk. In *IES*, the taxpayer purchased and sold the ADRs within hours while the U.S. and European markets were closed to lock in the price, but was deemed to have held the shares over the dividend date because the sale did not settle until after the record date of the dividend. 253 F.3d at 352, 355. In *Compaq*, special NYSE settlement terms were used such that the effective purchase date of the shares was prior to the record date of the dividend. 277 F.3d at 780, 787. By contrast, this case involves the creation of a Trust with $6.7 billion of assets that could not be withdrawn without Barclays' consent. They were encumbered for five years and not available as collateral for other transactions, which represented a real economic cost, as the Government's own expert acknowledged. C.A. Appendix 76.

III. Review Is Necessary To Clarify That The Economic Substance Doctrine Is Not A Stand-Alone Rule That Can Be Employed To Frustrate Congressional Intent.

The Government acknowledges that "anti-abuse doctrines should not be applied in a way that would subvert particularized legislative determinations." BIO 23. This basic limitation on judicial review is inherent in the application of all tools of statutory construction, including the economic substance doctrine, because it rests on core separation-of-powers principles. *City of Milwaukee v. Illinois & Michigan*, 451 U.S. 304, 314-15 (1981). Like other tools of statutory construction, the economic substance doctrine requires examination of the "particularized" text and purpose of statutory and regulatory provisions when the Government invokes the doctrine to nullify the legal effect of Code-compliant transactions. *Summa Holdings Inc. v. Comm'r*, 848 F.3d 779, 787 (6th Cir. 2017) (Sutton, J.) ("what is at issue in each of these cases [is] the meaning of words in the Code").

The Sixth and D.C. Circuits have followed this classic statutory construction model when applying the economic substance doctrine. In *Summa Holdings* and *Horn v. Comm'r*, 968 F.2d 1229 (D.C. Cir. 1992), respectively, the courts declined the Government's request to nullify code-compliant transactions under the economic substance doctrine, finding that the "Tax Code provisions at issue . . . evidenced Congress's intent to authorize the particular tax benefits that were claimed." BIO 23.

In this case, however, the First Circuit applied the economic substance doctrine untethered from the

Code's particularized text. The Court of Appeals made no effort to tie its specific finding that foreign taxes were expenses, or its ultimate conclusion that STARS lacked economic substance, to any particular provision, or any particular words, in the Code. Under the First Circuit's approach, the doctrine cannot fairly be described as a "tool of statutory construction" at all, but as an extra-textual judicial overlay in an area in which Congress's judgment should be paramount.

The First Circuit's incorrect economic substance analysis was outcome determinative. The court reasoned that foreign taxes should be considered expenses because a portion of those taxes were "borne" by Sovereign's counter-party Barclays. Pet. App. 19a. The Government adopts this reasoning in its opposition, repeatedly relying on the assertion that Sovereign "receive[d] an effective refund (through Barclays) of approximately 50% of its U.K. taxes." BIO 4; *id.* at 3 (stating that Sovereign "recouped [from Barclays] a substantial portion of its U.K. tax"); *id.* at 12 (claiming Sovereign had not paid "the full amount of foreign tax" because "it had recouped approximately half of its foreign tax payments").

However, the Government does not deny that the statutory and regulatory regime governing foreign tax credits specifically contemplates and addresses this circumstance. Pet. 28-29. There is a "particularized legislative determination" within the foreign tax credit regime on this issue, and that determination evidences congressional intent to permit foreign tax credits "even if another party to a direct or indirect transaction with the taxpayer agrees, as part of the transaction, to assume the

taxpayer's foreign tax liability." Treas. Reg. § 1.901-2(f)(2)(i). Thus, the First Circuit's non-textual approach to economic substance caused it erroneously to conclude that Sovereign's foreign tax payments were expenses because they allegedly were "recouped" from Barclays, notwithstanding that such a finding subverts a specific implementing regulation.

The Government mischaracterizes Petitioner's argument as asserting 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," or that mere "enactment of the foreign tax credit regime reflects approval" of STARS. BIO 15, 16. Rather, as the Government itself acknowledges, where there is a particular determination within the statutory regime regarding the legal consequences of certain conduct, the economic substance doctrine – properly understood as a tool of statutory construction – cannot be used to subvert legislative intent on that specific issue. BIO 23. That is precisely the case here.

IV. The 2010 Codification Heightens The Need For This Court's Review.

The Government asserts that the Petition lacks "prospective importance" in light of Congress' 2010 codification of the economic substance doctrine. BIO 23-25. However, the Government offers no response to the showing in the Petition (35-37) that the codification reaffirmed the centrality and validity of existing case law, leaving in place the divergent approaches and outcomes that require this Court's intervention.

The Government asserts the codification "would supersede" the holdings of *Compaq* and *IES*. BIO 24. But on the question of the treatment of foreign taxes, Congress *rejected* a bill that would have overruled *Compaq* and *IES* by providing that "foreign taxes shall be taken into account as expenses in determining pre-tax profit." H. Conf. Rep. No. 111-299 at 61 (2009), and instead instructed 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 Government acknowledges that Treasury has not issued any regulations to date and the IRS has chosen to deal with this question "case by case." BIO 24. In the interim, the IRS has explained the statutory directive to issue regulations "does *not* restrict the ability of the courts to consider the appropriate treatment of foreign taxes in economic substance cases." Notice 2010-62, I.R.B. 2010-40 at 412 (emphasis added). The caselaw dealing with the proper treatment of foreign income taxes therefore is directly relevant to the application of the new provisions, including "in appropriate cases," whether such cases involve transactions before or after codification.

The Government notes that one of the requirements for satisfying the codified economic substance test, as set forth in 26 U.S.C. § 7701(o)(1)(A) is a showing that "the transaction changes in a meaningful way (*apart from Federal income tax effects*) the taxpayer's economic position." BIO 23. The Government mistakenly takes this language to mean that only U.S. tax consequences should be excluded in calculating pre-tax profit. BIO 23. But the language is not so expansive. It

precludes a taxpayer from relying on U.S. tax savings as evidence that its economic position has changed in a meaningful way. But it says nothing about whether foreign taxes are included or excluded from the pre-tax profit determination.

Nor is the government correct that the 2010 codification eliminates any need to consider the nature and scope of judicial anti-abuse doctrines. BIO 24. Section 7701(o)(5)(A) states that "the term 'economic substance doctrine' means the common law doctrine under which tax benefits … 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 IRS then issued this guidance: "The IRS will continue to rely on relevant case law under the common-law economic substance doctrine in applying the two-prong conjunctive test in section 7701(o)(1)." Notice 2010-62, I.R.B. 2010-40, 411.

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

The Government notes in passing this Court's prior denial of the petitions in Nos. 15-380 and 15-572 (BIO 11), but it offers no response to the showing in the Petition (33-37) that those decisions should not dissuade the Court from granting review now. This Court often grants petitions after denying previous ones raising the same question. *E.g.*, *Salman v. United States*, 137 S. Ct. 420, 424 (2016); *see also R. Simpson & Co. v. Comm'r*, 321 U.S. 225, 229 (1944) ("A grant in such a case [where a writ of certiorari was previously denied] not only enables us to do justice to the party if it appears that he has the right of the controversy, but also it gives us the

benefit of argument and examination of the additional or contrary aspects of the question presented by the case.”).

CONCLUSION

The petition for writ of certiorari should be granted.

Respectfully submitted,

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