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In or Out: How to Treat Foreign Taxes Under the Economic Substance Doctrine

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I. Introduction

Corporations engage in business transactions for a wide variety of reasons. Doing so purely to obtain an illegitimate tax advantage, however, is not permissible.[1] Generally, business transactions "must serve a bona fide business purpose (i.e., not just . . . tax avoidance [purposes]) to qualify for beneficial tax treatment."[2] To determine whether a legitimate business purpose exists, the Internal Revenue Service (IRS) and the courts look to the economic substance doctrine.[3] The doctrine "is a common-law rule that allows courts to question the validity of a transaction and deny taxpayers benefits to which [they] are technically entitled under the Code if the transaction at issue lacks 'economic substance.'"[4]

A circuit split has emerged, however, and the application of this doctrine has become more complicated, possibly affecting hundreds of millions of dollars in foreign tax credits. The U.S. Courts of Appeals for the Federal Circuit[5] and the Second Circuit,[6]

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1. *See* Stobie Creek Invs. LLC v. United States, 608 F.3d 1366, 1375 (Fed. Cir. 2010) (arguing that courts "[seek] to distinguish between structuring a real transaction in a particular way to obtain a tax benefit, which is legitimate, and creating a transaction to generate a tax benefit, which is illegitimate").

2. *Business-Purpose Doctrine*, BLACK'S LAW DICTIONARY (10th ed. 2014).

3. *See* Richard M. Lipton, *"Codification" of the Economic Substance Doctrine—Much Ado About Nothing*, SS017 ALI-ABA 1035, 1035 (2010) [hereinafter Lipton, *"Codification" of the Economic Substance Doctrine*] (describing "[t]he economic substance doctrine as one of the long standing judicial doctrines").

4. *Id.* (citing Gregory v. Helvering, 293 U.S. 465, 468–70 (1935)).

5. *See generally* Salem Fin., Inc. v. United States, 786 F.3d 932 (Fed. Cir. 2015).

6. *See* Bank of N.Y. Mellon Corp. v. United States, 801 F.3d 104, 117–18 (2d Cir. 2015), *cert. denied*, 136 S. Ct. 1377 (2016) (expressly declining to follow the Fifth and Eighth Circuits' prior reasoning).

on the one hand, and the Fifth[7] and Eighth[8] Circuits, on the other, disagree about how to apply the objective prong of the economic substance doctrine to disputed transactions.[9] Specifically, the issue is whether foreign income taxes should be included in the calculation of pre-tax profits when determining if a transaction has meaningfully altered the taxpayer's economic position.[10] Resolving this issue is crucial, because the economic substance doctrine functions as the gatekeeper for foreign tax credits. Depending on the courts' application of the doctrine, taxpayers may be awarded—or denied—hundreds of millions of dollars in foreign tax credits. A split amongst the courts leads to uncertainty for both taxpayers and the government alike.

This Note attempts to resolve this split by suggesting that, when calculating pre-tax profits under the objective prong of the economic substance doctrine, foreign income taxes should be treated as expenses. Part II examines the economic substance doctrine itself. In this regard, the focus is on the history and origin, modern conception and use, and recent clarification of the doctrine into the Internal Revenue Code.[11] Part III focuses on the circuit split. The cases are discussed chronologically, beginning with the Eighth and Fifth Circuits, followed by the Federal and Second Circuits. The discussion puts particular emphasis on the underlying transactions that give rise to the disputes, and the objective prong of the doctrine.[12] Part IV discusses pending litigation in other jurisdictions, which may have an impact on the circuit split. Particularly, this Part focuses on the recent opinion by the First Circuit as a case study and current federal district

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7. *See generally* Compaq Comput. Corp. v. United States, 277 F.3d 778 (5th Cir. 2001).

8. *See generally* IES Indus., Inc. v. United States, 253 F.3d 350 (8th Cir. 2001).

9. *See Bank of N.Y. Mellon Corp.*, 801 F.3d at 113 (inquiring whether the taxpayer's transaction had a meaningful chance to generate a profit).

10. *See id.* at 117–18 (concluding that foreign taxes should be considered expenses when calculating pre-tax profits under the objective prong of the economic substance doctrine and stating that "both the *Compaq* and *IES* courts declined to consider the foreign taxes paid and foreign tax credits claimed in their economic substance analysis").

11. *Infra* Part II.

12. *Infra* Part III.

court litigation.[13] Part V recommends that the circuit split be decided in favor of the Federal and Second Circuits' points of view, namely that foreign taxes should be treated as expenses when determining the potential for pre-tax profits. The Part discusses the reasons for choosing this resolution and the legislative, regulatory, and judicial options for resolution.[14] Part VI concludes by summarizing the arguments, and offering a solution for this issue.[15]

II. The Economic Substance Doctrine

To understand the economic substance doctrine, it is important to understand in which contexts it applies. Generally, a taxpayer's transaction must comply with "the detailed language of a tax statute."[16] However, "at times a court subjects a taxpayer to . . . [scrutiny] even though the taxpayer complied with the literal language of the tax statute."[17] In such cases, courts may look past the exact language of a statute.[18] Courts do so by applying a common law doctrine that has come to be known as the economic substance doctrine. Yet, the application of the doctrine has proven not to be straightforward.

A. History and Modern Use of the Economic Substance Doctrine

The history of the economic substance doctrine is difficult to delineate.[19] Other doctrines that courts developed around the same time are the business purpose doctrine[20] and the sham

13. *Infra* Part IV.

14. *Infra* Part V.

15. *Infra* Part VI.

16. *See* William J. Kolarik II & Steven N.J. Wlodychak, *The Economic Substance Doctrine in Federal and State Legislation*, 67 TAX LAW. 715, 721 (2014) (requiring a taxpayer to determine, as a preliminary matter, whether an "activity falls within or without the statute's text").

17. *Id.*

18. *See id.* (focusing instead on the legislative intent and "the statute's underlying justification").

19. *See id.* at 723 (stating that the economic substance doctrine developed simultaneously with other tax avoidance doctrines).

20. *See* United Parcel Serv. of Am., Inc. v. Comm'r, 254 F.3d 1014, 1018

transaction doctrine.[21] On the one hand, the business purpose doctrine looks into the subjective intent of the taxpayer, providing "that a tax statute will not be applied to a transaction unless the transaction serves some business purpose, other than tax avoidance."[22] On the other hand, the sham transaction doctrine focuses on the objective character of the transaction, namely, *inter alia*, whether a transaction had a reasonable chance for profits.[23]

Arguably, the economic substance doctrine incorporates these two doctrines.[24] This has prompted commentators to note that these concepts are "often commingled" and used interchangeably.[25] Nevertheless, the business purpose doctrine, the sham transaction, and the economic substance doctrine all originated from the case *Helvering v. Gregory*[26] in 1934.[27]

In *Gregory*, Judge Learned Hand laid the foundation for establishing the economic substance doctrine as it exists today.[28] The plaintiff, Mrs. Gregory, aimed to eliminate tax consequences from the sale of shares of a United Mortgage Corporation (UMC) subsidiary, of which she was the sole shareholder.[29] To achieve

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(11th Cir. 2001) (stating that a business purpose exists "as long as it figures in a bona fide, profi-seeking business").

21. *See id.* (noting that the sham doctrine is synonymous with the economic substance doctrine, "provid[ing] that a transaction ceases to merit tax respect when it has no economic effects other than the creation of tax benefits").

22. Noöl B. Cunningham & James R. Repetti, *Textualism and Tax Shelters*, 24 VA. TAX REV. 1, 21 (2004) (citations omitted).

23. *See* Timothy H. Gillis & Ann L. Holley, *States Apply the Federal Sham Transaction Doctrine to Intangibles Holding Companies*, 98 J. TAX'N 173, 176 (2003) (noting that this is often used interchangeably with the term "economic substance" (quoting Rice's Toyota World, Inc. v. Comm'r, 752 F.2d 89, 96 (4th Cir. 1985))).

24. *See infra* note 80 and accompanying text (combining the two doctrines by using the word "and" to express that both elements are needed).

25. *See* Gillis & Holley, *supra* note 23, at 176 (describing the doctrines and providing examples of cases in which the doctrines were applied).

26. 69 F.2d 809 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935).

27. *See id.* at 810–11 (disallowing tax exemption for the taxpayer's business reorganization, made for purely tax reasons, because Congress did not intend for taxpayers to use the underlying statutory provision in such a way).

28. *See* Kolarik II & Wlodychak, *supra* note 16, at 722, 724 (stating that Judge Hand developed the doctrine "in his [struggle] to find a workable solution to the problem of tax avoidance").

29. *See Gregory*, 69 F.2d at 810 ("In 1928 it became possible to sell

this, Mrs. Gregory established another corporation through which she would be able to avoid the tax through corporate reorganization.[30]

The Commissioner of Internal Revenue rejected Mrs. Gregory's tax structure, "determining that the transaction lacked substance and was entered into solely for tax avoidance purposes."[31] Writing for the Second Circuit, Judge Hand agreed with the Commissioner, concluding that Mrs. Gregory entered into the reorganization for no other reason but to avoid her taxes.[32] Subsequently, the Supreme Court affirmed the Second Circuit's decision, "finding that Mrs. Gregory's transaction was in pursuance of a plan to reduce her taxes which '[had] *no business purpose*,' which it determined to be the prerequisite for corporate reorganizations."[33] Arguably, *Gregory* marks the first foray into what would eventually evolve into part of the economic substance doctrine.[34] Yet, the doctrine's development progressed slowly.

More than twenty years later, Judge Hand issued a dissenting opinion in *Gilbert v. Commissioner*,[35] which provided a more comprehensive formulation of the doctrine.[36] In *Gilbert*, the Second Circuit determined whether a shareholder advance should be treated as a loan or a capital contribution.[37] The plaintiffs, Benjamin and Madeline Gilbert, were both involved in Gilbor,

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the . . . shares . . . but if this had been done directly, [UMC] would have been obliged to pay a normal tax on the resulting gain, and . . . a surtax would have been assessed against [Gregory] personally [for the dividends paid from the sale].").

30. *See id.* at 810 (providing a detailed description of the exact steps and tax code provisions at issue); *see also* Monica D. Armstrong, *OMG! ESD Codified!: The Overreaction to Codification of the Economic Substance Doctrine*, 9 FLA. A&M UNIV. L. REV. 113, 118–20 (2013) (same).

31. Armstrong, *supra* note 30, at 120.

32. *See Gregory*, 69 F.2d at 810 ("To dodge the shareholders' taxes is not one of the transactions contemplated as corporate 'reorganizations.'").

33. Armstrong, *supra* note 30, at 121 (quoting Gregory v. Helvering, 293 U.S. 465, 469–70 (1935)).

34. *See* Gregory v. Helvering, 293 U.S. 465, 469–70 (1935) (describing what would later become the subjective prong—the business purpose inquiry).

35. 248 F.2d 399 (2d Cir. 1957).

36. *See id.* at 411 (Hand, J., dissenting) (noting the need for an objective inquiry into the transaction, and not merely the intent of the taxpayer).

37. *See id.* at 400 (dealing with the specific question of which principle to apply to adequately answer the issue).

Inc. (Gilbor), which had been involved in numerous unsuccessful business ventures.[38] Due to these unsuccessful ventures, the Gilberts made additional investments into Gilbor "that were structured as loans."[39] Subsequently, Gilbor liquidated and the Gilberts "claimed bad debt deductions on their 1948 joint income tax return."[40]

The Commissioner denied the Gilberts' deductions, arguing that the loans were in fact capital contributions, which would not have given rise to bad debt deductions.[41] The Tax Court agreed and the Gilberts appealed to the Second Circuit.[42] While the majority decided not to rule and remanded the case for further proceedings, Judge Hand found strong words in favor of a substantive approach for analyzing the transaction.[43] He argued that not only must a taxpayer's business purpose be legitimate and within the framework of the statute at issue, it must also "appreciably affect his beneficial interest."[44] This marked one of the first references to both of the factors of the economic substance doctrine up to that date. It would be another few years before the next development on the economic substance doctrine occurred.

In 1960, the Supreme Court of the United States adopted Judge Hand's approach from *Gilbert* in *Knetsch v. United States*.[45] The case "involve[d] . . . classic . . . tax arbitrage."[46] *Knetsch*

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38. *See* Kolarik II & Wlodychak, *supra* note 16, at 736 (noting that although only Benjamin Gilbert was a shareholder in Gilbor and Madeline was not, she was still strongly involved in the company).

39. *Id.*

40. *Id.*

41. *See Gilbert*, 248 F.2d at 402 (ruling that the Gilberts' contributions were not "bona fide loans" and even though Madeline's contributions were loans, they were not within her trade or business).

42. *Id.* at 410.

43. *See id.* at 410–12 (providing an inquiry into the taxpayer's subjective intent as well as the objective circumstances surrounding the transactions).

44. *See id.* at 411 (concluding that if a taxpayer's transaction does not fulfill these requirements, the tax authorities may disregard the transaction, as it could not conceivably be the purpose of the tax code to allow taxpayers to "escape from the liabilities that it sought to impose").

45. *See* Knetsch v. United States, 364 U.S. 361, 366 (1960) (finding that "Kentsch's [sic] transaction with the insurance company did 'not appreciably affect his beneficial interest except to reduce his tax'" (quoting Gilbert v. Comm'r, 248 F.2d 399, 411 (2d Cir. 1957) (Hand, J., dissenting))).

46. Kolarik II & Wlodychak, *supra* note 16, at 744.

involved complicated transactions concerning debt-financed single-premium annuities.[47] In 1953, the plaintiff, Mr. Knetsch purchased such an annuity from Sam Houston Life Insurance Company.[48] However, "the Service discovered that Sam Houston . . . was marketing the . . . annuity transactions as a tax shelter strategy and began challenging the transactions."[49] Due to a circuit split on the issue, the United States Supreme Court granted certiorari.[50]

Justice Brennan, writing for the majority, adopted Judge Hand's approach set forth in *Gilbert*.[51] He concluded that "there was nothing of substance to be realized by Knetsch from this transaction beyond a tax deduction."[52] While Justice Brennan explicitly referred to what was arguably the objective economic substance component, his analysis into the taxpayer's business purpose was rather implicit.[53] After discussing the individual steps, Justice Brennan concluded that Knetsch's transaction was not aligned with the purpose of the statute and that "the transaction was a sham."[54]

The cases up to this point constitute the basis for what would become today's economic substance doctrine. Judge Hand's pursuit to combat tax avoidance schemes in *Gregory* and *Gilbert*

47. *See Knetsch*, 364 U.S. at 362 (involving a series of transactions surrounding a 30-year maturity deferred annuity savings bond). For the purposes of this Note, it is not necessary to discuss the detailed steps of these transactions. *See* Kolarik II & Wlodychak, *supra* note 16, at 744 (providing a step-by-step account of the transactions a taxpayer would enter into to obtain the desired tax benefits).

48. *See Knetsch*, 364 U.S. at 362 ("[T]he insurance company sold Knetsch ten 30-year maturity deferred annuity savings bonds, each in the face amount of $400,000 . . . .").

49. Kolarik II & Wlodychak, *supra* note 16, at 745.

50. *See Knetsch*, 364 U.S. at 362 (aiming to resolve a split between the Ninth and Fifth Circuits).

51. *See id.* at 366 ("Plainly, therefore, [the] transaction with the insurance company did 'not appreciably affect [Knetsch's] beneficial interest except to reduce his tax . . . .'" (quoting Gilbert v. Comm'r, 248 F.2d 399, 411 (2d Cir. 1957) (Hand, J., dissenting))).

52. *Id.*

53. *See id.* at 365–66 (engaging in an analysis of "what was done here," namely Knetsch's intention to generate large insurance payouts).

54. *See id.* (agreeing with the trial court that Knetsch did not "intend" to be indebted to Sam Houston Insurance, but rather was only focused on producing favorable tax consequences).

led him to conclude that it was necessary to examine, not only the taxpayer's mind, but also the transaction itself.[55] Eventually, the Supreme Court agreed, and in *Knetsch* stated: "[T]hrough its adoption of Judge Hand's *Gilbert* test, place[d] the economic substance doctrine in the income tax common law."[56] However, the economic substance doctrine still did not have a concise definition. This changed with *Frank Lyon Co. v. United States*.[57]

Some commentators regard *Frank Lyon* as the most important case in the development of the economic substance doctrine.[58] The case concerned the Frank Lyon Company, a corporation that attempted to enter into a sale-leaseback transaction[59] with the Worthen Bank & Trust Company (Worthen).[60] Additionally, "Frank Lyon was Lyon's majority shareholder and board chairman; [and] he also served on Worthen's board."[61] Worthen planned to construct a new bank

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55. *See supra* notes 19–49 and accompanying text (describing the individual elements of the doctrine).

56. Kolarik II & Wlodychak, *supra* note 16, at 745.

57. *See* Frank Lyon Co. v. United States, 435 U.S. 561, 582–84 (1978) (emphasizing both the taxpayer's motivation and the economic significance of the transaction for the taxpayer's business).

58. *See* Kolarik II & Wlodychak, *supra* note 16, at 746 (arguing that it was the case in which the economic substance doctrine was formally adopted); Allen D. Madison, *The Tension Between Textualism and Substance-Over-Form Doctrines in Tax Law*, 43 SANTA CLARA L. REV. 699, 701 (2003) (noting that *Frank Lyon* marked the last case in which the Supreme Court applied a substance-over-form analysis to the merits of a case); Philip Sancilio, Note, *Clarifying (or Is It Codifying?) the "Notably Abstruse": Step Transactions, Economic Substance, and the Tax Code*, 113 COLUM. L. REV. 138, 144 (2013) (describing the Supreme Court's formulation of the economic substance doctrine as its "final (at least as far as the Court was concerned) and distinctive form").

59. *See Frank Lyon*, 435 U.S. at 561 (stating that "petitioner took title to the building and leased it back to the bank for long-term use"). For a detailed description of sale-leaseback transactions and their application, see generally TERREL G. BRESSLER & TYLER C. WILLIBRAND, SALE-LEASEBACK TRANSACTIONS: A FINANCING ALTERNATIVE FOR MIDDLE MARKET COMPANIES (2011), http://www.srr.com/assets/pdf/sale-leaseback-transactions-financing-alternative-middle-market-companies.pdf.

60. *See Frank Lyon*, 435 U.S. at 563 (noting that Worthen was part of the Federal Reserve System, and was thus subject to the appropriate regulations applicable to the banks belonging to the system); Kolarik II & Wlodychak, *supra* note 16, at 747 (describing the transaction between the two entities as a "financing transaction").

61. *Frank Lyon*, 435 U.S. at 563.

building to replace the existing building, but was unable to do so due to the Federal Reserve regulations.[62] Instead, Worthen devised a plan to enter into a sale-leaseback transaction, which the State Bank Department and the Federal Reserve System ultimately approved.[63] Worthen—following the third-party bidding process and the successful securing of financing from a third-party insurance company—entered into a sale-leaseback agreement with Frank Lyon Company.[64] Subsequently, "Worthen agreed to sell the building to the Frank Lyon Company piece by piece as Worthen constructed the building for a total price not to exceed $7.6[4] million."[65] Because the sale price exceeded the financing amount by $500,000, the difference "was effectively an investment in the building by Frank Lyon Company."[66]

On Frank Lyon Company's federal tax return following the completion of the building, the company sought to deduct one month of depreciation on the building, interest on the construction loan, and various legal and other expenses connected to the transactions.[67] The Internal Revenue Service disallowed the deductions, stating that because the Frank Lyon Company did not own the building, it was not entitled to claim these tax benefits.[68] The district court disagreed with the Internal Revenue Service, reasoning that "the legal intent of the parties had been to

62. *See id.* at 564 (elaborating that "[a]pplicable statutes or regulations of . . . the Federal Reserve System required Worthen . . . to obtain prior permission for the investment in banking premises," which the Federal Reserve would not approve).

63. *See id.* at 565 (requiring that "Worthen possess an option to purchase the leased property at the end of the 15th year of the lease at a set price, and . . . that the building be owned by an independent third party"). Although the price was not to exceed $7.64 million, the building ended up costing over $10 million. *Id.* at 569.

64. *See id.* (noting that the financing that Worthen obtained amounted to $7.14 million).

65. *See* Kolarik II & Wlodychak, *supra* note 16, at 748 (describing the sale as a series of transactions to be executed over the duration of the construction).

66. *See id.* (receiving in addition six percent interest on the value of the investment).

67. Frank Lyon Co. v. United States, 435 U.S. 561, 568 (1978).

68. *See id.* ("All this resulted in a total increase of $497,219.18 over Lyon's reported income for 1969, and a deficiency in Lyon's federal income tax for that year in the amount of $236,596.36. The Commissioner assessed that amount, together with interest of $43,790.84, for a total of $280,387.20.").

create a bona fide sale-and-leaseback in accordance with the form and language of the documents evidencing the transactions."[69]

On appeal, the Eighth Circuit reversed the district court's decision, following the IRS's line of reasoning.[70] Analogizing the ownership for tax purposes to "a bundle of sticks," the court stated that the Frank Lyon Company "totes an empty bundle of ownership sticks."[71] The court of appeals concluded that Lyon's only economic advantage was income tax savings.[72]

The United States Supreme Court reversed the Eighth Circuit's decision, upholding the deductions.[73] The majority, for which Justice Blackmun wrote the opinion, "engaged in a two-step analysis similar to the *Gilbert* analysis."[74] The majority reasoned that the appropriate analysis was whether "there is a genuine multiple-party transaction with economic substance that is compelled or encouraged by business or regulatory realities, that is *imbued with tax-independent considerations*, *and* that is *not shaped solely by tax-avoidance features* to which meaningless labels are attached."[75]

Applying this test, Justice Blackmun concluded that this was not the case because: "Lyon is not a corporation with no purpose other than to hold title to the bank building,"[76] meaning that the

69. *Id.* at 569.

70. *See id.* at 570 (claiming "that Lyon was not the true owner of the building and therefore was not entitled to the claimed deductions").

71. *Id.* at 570.

72. *See id.* at 572 ("In sum, the benefits, risks, and burdens which [Lyon] has incurred with respect to the Worthen building are simply too insubstantial to establish a claim to the status of owner for tax purposes.").

73. *See id.* at 583 (finding "a genuine multiple-party transaction with economic substance").

74. Kolarik II & Wlodychak, *supra* note 16, at 749.

75. Frank Lyon Co. v. United States, 435 U.S. 561, 583–84 (1978) (emphasis added); *see also* Sancilio, *supra* note 58, at 144 (describing the Supreme Court's formulation of the doctrine a "negative" one); Thomas C. Vanik Jr., *Torpedoing a Transaction: Economic Substance Versus Other Tax Doctrines and the Application of the Strict Liability Penalty*, 64 CLEV. ST. L. REV. 109, 115 (2015) (marking this phrasing as the moment when "[t]he business purpose doctrine and economic substance principle were ultimately combined into what has become known as the 'economic substance doctrine'").

76. *Frank Lyon*, 435 U.S. at 561.

parties' "collective actions created a sale-leaseback for nontax purposes."[77]

From a conceptual perspective, *Frank Lyon* did not alter the economic substance doctrine much.[78] It was the first time, however, in which a court described the test in a conjunctive manner, laying out the elements in their entirety.[79] Thus, based on *Frank Lyon*, a transaction has economic substance, provided it passes a two-prong inquiry: "Was the taxpayer motivated by no business purpose (other than getting tax benefits) in entering into the transaction? . . . [And] [d]id the transaction have objective economic substance, i.e., was there a reasonable possibility of a profit?"[80]

Following *Frank Lyon*, "lower courts drew on the Supreme Court precedent to formulate many more or less divergent versions of the economic substance doctrine."[81] While all courts used the doctrine to one extent or another, the application differed considerably, creating three basic schools of application: disjunctive,[82] conjunctive,[83] and the so-called

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77. Kolarik II & Wlodychak, *supra* note 16, at 750.

78. *See id.* (arguing that the methodology of the doctrine, namely looking at the business purpose and objective factors of the transaction, had already been established in *Gregory*, *Gilbert*, and *Knetsch*).

79. *See supra* note 75 and accompanying text (using the word "and" to combine the subjective and objective element).

80. *See* Paul Raymond, *District Court Upholds Interest Deductions and Foreign Tax Credits from STARS Transaction*, ORANGE CTY. TAX ATT'Y, http://octaxlawattorney.com/district-court-upholds-interest-deductions-and-foreign-tax-credits-from-stars-transaction/ (last visited Apr. 14, 2018) (constituting the subjective prong and the objective prong, respectively (citing Frank Lyon Co. v. United States, 435 U.S. 561 (1978))) (on file with the Washington and Lee Law Review).

81. *See* Sancilio, *supra* note 58, at 144 n.29 (noting that the Supreme Court never explicitly labeled the prongs as the economic substance doctrine, and that other courts have often used the term interchangeably with the term "sham doctrine" and other tax avoidance doctrines).

82. *See* ACM P'ship v. Comm'r, 157 F.3d 231, 247 (3d Cir. 1998) ("However, these distinct aspects of the economic sham inquiry 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.").

83. *See* Rice's Toyota World, Inc. v. Comm'r, 752 F.2d 89, 91 (4th Cir. 1985) ("To treat a transaction as a sham, court must find that the taxpayer was motivated by no business purposes other than obtaining tax benefits in entering the transaction, *and* that the transaction has no economic substance because no

"flexible inquiry."[84] The increasing uncertainty and the emerging circuit splits prompted Congress to act.

B. Clarification of the Economic Substance Doctrine

In 2010, "[a]s part of the Health Care and Education Reconciliation Act of 2010 . . . Congress enacted new Section 7701(o), which provides for the 'codification' of the economic substance doctrine and the addition of substantial penalties for transactions that are found to lack economic substance."[85] This "codification" was met with stark resistance.[86] As a compromise, the section was implemented into the tax code not as a "codification," but rather as a "clarification."[87]

Prior to 2010, courts disagreed about how to apply the subjective and objective prongs of the doctrine.[88] The "clarification" of the economic substance doctrine specified that a transaction must satisfy *both* prongs to have economic

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reasonable possibility of a profit exists." (emphasis added)).

84. *See* Bank of N.Y. Mellon Corp. v. Comm'r, 801 F.3d 104, 115 (2d Cir. 2015) ("In our Circuit the test is not a rigid two-step process with discrete prongs; rather, we employ a 'flexible' analysis where both prongs are factors to consider in the overall inquiry into a transaction's practical economic effects.").

85. Lipton, *"Codification" of the Economic Substance Doctrine*, *supra* note 3, at 1037. The main impetus for this codification, and especially the new strict liability penalties, was to provide for an additional revenue booster to finance the Affordable Care Act (ACA). Initially, the estimated revenue was calculated to be $17.5 billion. *Id.*

86. *See id.* (noting that the administration opposed the codification "out of concern that the proposal would reduce the courts' ability to use the economic substance doctrine to address taxpayer abuses").

87. *See* 26 U.S.C. § 7701(o) (2012) (describing the subsection as a "clarification" in the heading, rather than a "codification"); Lipton, *"Codification" of the Economic Substance Doctrine*, *supra* note 3, at 1037 (same); Charlene D. Luke, *The Relevance Games: Congress's Choices for Economic Substance Gamemakers*, 66 TAX LAW. 551, 551 n.2 (2013) (arguing that the "codification of the economic substance doctrine was among the most controversial tax items contained in the health care legislation").

88. *Compare Rice's Toyota World, Inc.*, 752 F.2d at 96 (allowing an interest deduction where the transaction was purely tax motivated but had an element of economic substance), *with* United Parcel Serv. of Am., Inc. v. Comm'r, 254 F.3d 1014, 1018 (11th Cir. 2001) (stating that "[e]ven if the transaction has economic effects, it must be disregarded if it has no business purpose and its motive is tax avoidance" (citations omitted)).

substance.[89] In other words, courts interpret the economic substance doctrine as a conjunctive two-part test. This alleviated much confusion and disparate treatment, and is arguably in line with the original concept of the economic substance doctrine as envisioned under *Frank Lyon*.[90]

While this was the main issue Congress addressed in the clarification, it was not the only one. In addition to mandating a conjunctive analysis, Congress added more elements to the clarification.[91] For the purposes of this Note, the key clarification applies to the treatment of fees and foreign taxes.[92] To fully understand this subsection, scrutiny of the text of the subsection and an analysis of the legislative history is crucial.

Subsection 7701(o)(2)(B) is split into two sentences; the first deals with fees and other transaction expenses, and the second deals exclusively with foreign taxes.[93]

The first sentence is styled in the form of a command, leaving no possibility for deviation.[94] Although the second sentence, concerning foreign taxes, seems equally definitive at first glance, closer examination reveals that it is not.[95] The second sentence, similarly to the first, stipulates that foreign taxes "shall" be treated as expenses.[96] Unlike the first sentence, the second

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89. *See* 26 U.S.C. § 7701(o) (stating that a transaction has economic substance "only if" the first "and" the second prong are fulfilled).

90. *Supra* notes 75, 79 and accompanying text.

91. *See generally* THOMAS E. TAYLOR, CODIFICATION OF THE ECONOMIC SUBSTANCE DOCTRINE BY THE HEALTH CARE AFFORDABILITY RECONCILIATION ACT OF 2010 (2010), https://www.mcguirewoods.com/news-resources/publications/taxation/Economic%20Substance%20Codification.pdf (listing additional elements, including the treatment of state and local taxes, certain financial accounting benefits, application to individuals, and a reference to penalties).

92. *See generally* 26 U.S.C. § 7701(o)(2)(B).

93. *See id.* ("Fees and other transaction expenses shall be taken into account as expenses in determining pre-tax profit under subparagraph (A). The Secretary shall issue regulations requiring foreign taxes to be treated as expenses in determining pre-tax profit in appropriate cases.").

94. *See id.* (using the word "shall" to describe the mandatory nature of the clause); *Shall*, MERRIAM-WEBSTER, https://www.merriam-webster.com/dictionary/shall (last visited Feb. 9, 2017) (describing that the word "shall" is "used in laws, regulations, or directives to express what is mandatory") (on file with the Washington and Lee Law Review).

95. *See* 26 U.S.C. § 7701(o)(2)(B) (2012) (using various qualifiers which must be fulfilled before the provision can come into effect).

96. *Id.*

sentence only applies once the Secretary of the Treasury issues regulations on the matter "in appropriate circumstances."[97] Neither the subsection itself, nor the notes of the Joint Committee on Taxation on the clarification of the economic substance doctrine, provide any guidance regarding the term "appropriate circumstances," or which taxes the provision specifically covers.[98]

From a structural point of view, it is reasonable to assume that it was not Congress's intention to stipulate a rigorous rule regarding foreign taxes. Had Congress intended to do so, it could have simply included foreign taxes within the first sentence, leaving no room for doubt. Yet, Congress chose to separate foreign taxes, requiring administrative action limited to certain undefined circumstances.[99]

While the Joint Committee on Taxation's General Explanation of Tax Legislation does not provide any guidance on the term "appropriate circumstances," it does provide limited guidance on the legislative intent behind the clause. In their explanation of the clause, the committee notes that "[t]here is no intention to restrict the ability of the courts to consider the appropriate treatment of foreign taxes in particular cases, as under present law."[100] This statement supports a less rigorous reading of the second sentence of § 7701(o)(2)(B). As in the subsection itself, the legislative intent makes use of the qualifiers "in particular cases," and "under present law."[101] Again, the committee provides no guidance on what these two terms entail.

The most important part of the statement is the intention to provide deference to the courts to determine their own treatment of foreign taxes when calculating pre-tax profits.[102] This phrase provides a clear indication that Congress did not intend to take authority from the courts regarding the treatment of foreign

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97. *Id.*

98. *See generally id.*; JOINT COMM. ON TAX., 111TH CONG., GENERAL EXPLANATION OF TAX LEGISLATION, JCS–2–11 (Comm. Print. 2011). The author was unable to locate any other source discussing the doctrine.

99. 26 U.S.C. § 7701(o)(2)(B).

100. JOINT COMM. ON TAX., *supra* note 98, at 381 n.1047.

101. *Id.*

102. *See id.* (referring specifically to "the ability of the courts to consider the appropriate treatment of foreign taxes").

taxes when calculating pre-tax profits, allowing courts to apply their own treatment.

The practical realities surrounding this clause support this reading of the subsection, as well as the legislative intent. The Secretary of the Treasury has not issued any such regulation.[103] Thus, based on this ambiguity and administrative inaction, a split between the circuits' treatment of foreign taxes regarding the calculation of pre-tax profits remains.[104]

III. The Circuit Split: Should Foreign Taxes Be Included in the Calculation of Pre-Tax Profits?

The split between the courts arises from a disagreement over the framework of the objective prong of the economic substance inquiry.[105] Specifically, the issue is whether foreign taxes should be included in the calculation of pre-tax profits when determining if a transaction has meaningfully altered the taxpayer's economic position.[106] On both sides of the split, the issue commonly arises in the context of cross-border securities transactions, specifically whether these transactions are purely tax motivated.[107] As mentioned, a resolution to this issue is crucial, as the interpretation of the objective prong of the economic substance doctrine determines whether taxpayers will receive hundreds of millions of dollars in foreign tax credits.[108]

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103. Petition for Writ of Certiorari at 33, Bank of N.Y. Mellon Corp. v. Comm'r, 2015 WL 6690397 (2015) (No. 15-572) [hereinafter Petition for Writ of Certiorari]. The Secretary has not promulgated any regulations as of the date of writing this Note.

104. *See id.* ("Absent any prospective regulation on that issue, courts continue to apply their own inconsistent rules.").

105. *Supra* note 10 and accompanying text.

106. *Supra* notes 5–8 and accompanying text.

107. *See* Rice's Toyota World, Inc. v. Comm'r, 752 F.2d 89, 117 (4th Cir. 1985) (discussing that economic substance must go beyond a mere tax gain).

108. *See* Petition for Writ of Certiorari, *supra* note 103, at 33 (listing various cases which concerned a combined total of over a billion dollars in foreign tax credits).

A. The Eighth Circuit: IES Industries, Inc. v. United States

The Eighth Circuit decision in *IES Industries, Inc. v. United States*[109] is chronologically the first decision in the split.[110] The case revolved around the IRS's denial of a tax refund to the taxpayer, IES.[111] The transactions at hand involved American Depository Receipts (ADRs).[112] Owners of such receipts are "entitled to all dividends and capital gains associated with the ADR, with those moneys taxable in the home country of the foreign corporation."[113] The owner is entitled to the dividend as of the "record date."[114]

Generally, the foreign corporation withholds the foreign tax due on such dividends before they are transferred to the U.S. taxpayer.[115] In this case, the applicable withholding rate was fifteen percent.[116] The result was that "the record owner is entitled to a 15% foreign tax credit, a dollar-for-dollar credit against U.S. taxes owed."[117] IES used a securities advisor to identify corporations to invest in.[118] Upon choosing a corporation,

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109. 253 F.3d 350 (8th Cir. 2001).

110. *See id.* at 350 (publishing the final decision on June 14, 2001). Discussing the cases chronologically is crucial, as the cases build upon and reference each other.

111. *See id.* at 351 (disallowing the tax refund at both the initial refund and district court stage because the transactions were "sham transactions").

112. *See id.* ("ADRs are publicly traded securities, or receipts, fully negotiable in U.S. dollars, that represent shares of a foreign corporation held in trust by a U.S. bank.").

113. *Id.*

114. *See Record Date*, INVESTOPEDIA, http://www.investopedia.com/terms/r/recorddate.asp?lgl=no-infinite (last visited Apr. 26, 2018) (describing "the cut-off date established by a company in order to determine which shareholders are eligible to receive a dividend or distribution") (on file with the Washington and Lee Law Review); *see also IES Indus., Inc.*, 253 F.3d at 351 (noting that the record date and the actual payment date may be several weeks apart).

115. *See IES Indus., Inc.*, 253 F.3d at 351 (noting that in this case, the foreign corporations which paid the tax were situated "in the United Kingdom, the Netherlands, and Norway").

116. *See id.* ("[T]he record owner of the ADR would receive 85% of the dividend in cash, but the gross income—100% of the dividend—would be fully taxable in the United States.").

117. *Id.*

118. *See id.* at 352 (noting that the securities firm chose companies which had announced a dividend).

"IES purchased ADRs with a[n] . . . effective trade date, before the record date for the dividend, so that IES was the owner on the record date and therefore entitled to be paid the dividend."[119] Immediately after the purchase, IES sold the ADRs so the effective trade date of the sale was after the record date.[120] In other words, IES bought the stock, including the right to the dividends, and immediately sold it without dividends, resulting in a capital loss.[121]

Despite the capital loss, IES still generated a profit due to the dividends.[122] This meant "IES retained the dividends, which were ordinary income to the company, paid the 15% foreign tax, and therefore claimed a 15% foreign tax credit in the United States."[123] The IRS, as well as the district court, disallowed the foreign tax credit, deductions for half of the foreign tax, and other claims.[124]

On appeal, the Eighth Circuit applied both prongs of the economic substance doctrine to determine whether IES's strategy passed muster.[125] In the court's view, a transaction constituted a sham if "'it [was] not motivated by any economic purpose outside of tax considerations' (the business purpose test), and if it 'is without economic substance because no real potential for profit

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119. *Id.*

120. *See id.* ("The purchase and sale generally took place within hours of each other, and sometimes in Amsterdam when the U.S. and European markets were closed.").

121. *See id.* (describing the purchase as "cum-dividend" and the sale as "ex-dividend").

122. *See id.* at 352 (stating that the dividend income exceeded the capital loss).

123. *Id.*

124. *See id.* at 353 (arguing the transactions were a sham and that they had no purpose or effect beyond tax).

125. *See id.* at 353–56 (applying both prongs despite declining to decide whether both prongs must be fulfilled to establish economic substance). Regarding the subjective prong of the economic substance doctrine, the court concluded that the transactions occurred at an arm's length basis under normal market conditions, and that normal market risks were involved. *See id.* at 355 (referring to the government's argument that the transactions were a sham because they involved no risk). The court noted that "[t]he legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted." *Id.* (citations omitted). Thus, the court concluded that IES had a legitimate business purpose for entering into the ADR transactions.

exists' (the economic substance test)."[126] In both instances the court stated that the transactions fulfilled the test.[127]

The most important aspect of the case appears in the Eighth Circuit's discussion of the objective element of the test—the economic substance prong. The government argued that the economic benefit of a transaction should be measured based on the net dividend, after deducting the foreign tax, rather than the gross dividend.[128] The result was that "the government would . . . regard only 85% of the dividends as income to IES, notwithstanding that the IRS treats 100% as income for tax purposes."[129]

The Eighth Circuit rejected this view and ruled that the economic benefit to IES should be assessed on the basis of gross dividends.[130] The fact that "IES received only 85% of the dividend in cash, is of no consequence to IES's liability for the tax."[131] Therefore, IES received an economic benefit from the transactions regardless of whether the foreign tax was deducted.[132] Based on this reasoning, the Eighth Circuit dismissed the IRS's claims, deciding that the transactions fulfilled both elements of the economic substance test.[133]

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126. *See id.* at 353 (describing the business purpose test as the subjective part, and the economic substance test as the objective part of the greater economic substance analysis (quoting Shriver v. Comm'r, 899 F.2d 724, 725–26 (8th Cir. 1990))).

127. *See id.* at 354 (applying a more in-depth review of the facts than the district court, the Eighth Circuit noted that "the ADR trades here had both economic substance and a business purpose").

128. *See id.* (noting that under that approach "benefit accrues to IES only if it receives the foreign tax credit").

129. *Id.*

130. *See id.* (stating that because IES was the legal owner of the dividends on the record date, the entire amount due on that date was considered income).

131. *Id.*

132. *See id.* (concluding that under this approach the transactions resulted in a net profit).

133. *See id.* at 359 (reversing the district court's findings and remanding for further proceedings).

B. The Fifth Circuit: Compaq Computer Corporation v. Commissioner

In *Compaq Computer Corporation v. Commissioner*,[134] the Fifth Circuit issued the second major decision concerning the application of the economic substance doctrine to foreign taxes.[135] The facts of the case are similar to those in the Eighth Circuit decision.[136] In this case, Compaq engaged in an ADR transaction to acquire stock in a Dutch entity.[137] Similarly to the transactions in *IES*, Compaq's gross dividend income and the foreign tax credit exceeded the sustained capital losses.[138] The Tax Court "disallowed the gross dividend income, the foreign tax credit, and the capital losses reported by Compaq on its tax return."[139]

The Fifth Circuit also applied the two-part economic substance test to determine whether the transaction was a sham or had economic substance.[140] The court noted that "[t]o treat a transaction as a sham, the court must find that the taxpayer was motivated by no business purposes other than obtaining tax benefits in entering the transaction, and that the transaction has no economic substance because no reasonable possibility of a profit exists."[141] This language closely resembles the language in

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134. 277 F.3d 778 (5th Cir. 2001).

135. *See id.* at 778 (issuing its decision approximately six months after the Eighth Circuit's decision).

136. *See id.* at 783 (noting that the ADR transactions at issue were virtually "identical" in terms of structure).

137. *See id.* at 779–80 (using the same securities corporation as IES to invest in Royal Dutch Petroleum Company).

138. *See id.* at 780 (amounting to approximately $20.7 million in capital losses, $22.5 million in gross dividend income, and $3.4 million in foreign tax credits); *see also* IES Indus., Inc. v. United States, 253 F.3d 350, 352 (8th Cir. 2001) (noting that the capital losses were offset by the dividends).

139. *Compaq Comput. Corp.*, 277 F.3d at 780.

140. *See id.* at 781 (resembling closely the Eighth Circuit's test, but finding its basis in a Fourth Circuit Decision (citing Rice's Toyota World, Inc. v. Comm'r, 752 F.2d 89 (4th Cir. 1985))).

141. *Id.* at 781 (quoting Rice's Toyota World, Inc. v. Comm'r, 752 F.2d 89, 91 (4th Cir. 1985)). In terms of the "business purpose" requirement, the Fifth Circuit rejected the tax court's argument that Compaq's transactions were motivated purely by tax benefits. *See id.* at 783 (relying in large parts on the Eighth Circuit's reasoning). The Fifth Circuit focused primarily on the facts that Compaq availed itself to the forces of the public market and that low risk is not itself indicative of a sham. *See id.* at 783–84, 786–87 (observing that the

the *IES* opinion.[142]

Regarding economic substance, the court stated that "[p]re-tax income is pre-tax income regardless of the timing or origin of the tax."[143] This meant that the tax that Compaq was required to pay in the Netherlands constituted income for U.S. tax purposes.[144] Thus, "the gross Royal Dutch dividend, not the dividend net of Netherlands tax, should have been used to compute Compaq's pre-tax profit."[145]

By including foreign taxes in pre-tax profits, the Fifth Circuit expressly declined to follow the Commissioner's rationale.[146] The court declined to accept that foreign taxes should be treated as expenses for economic profit determinations.[147] Thus, the Fifth Circuit took an approach identical to that of the Eighth Circuit. It is important to note that like the Eighth Circuit, the Fifth Circuit declined to decide whether the transaction needed to satisfy both elements of the economic substance doctrine to satisfy the doctrine as a whole.[148] However, the court acknowledged that other courts do not apply a strict two-step analysis, which set the stage for the other shoe to drop.[149]

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transaction was at arm's length and that even though it involved a low risk, Compaq carried risk nonetheless).

142. *See IES Indus., Inc.*, 253 F.3d at 355 ("Applying that test, a transaction will be characterized as a sham if 'it is not motivated by any economic purpose outside of tax considerations' (the business purpose test), and if it 'is without economic substance because no real potential for profit exists' (the economic substance test).").

143. Compaq Comput. Corp. v. Comm'r, 277 F.3d 778, 784 (5th Cir. 2001) ("In calculating his United States tax liability, the lender must include in gross income . . . the . . . tax paid (on his behalf) by the borrower to the . . . tax collector." (citing Riggs Nat'l Corp. v. Comm'r, 163 F.3d 1363, 1365 (D.C. Cir. 1999))).

144. *See id.* at 784–85 (stating that even the Commissioner agreed that the gross, and not the net, dividends need to be reported in the U.S.).

145. *Id.* at 785.

146. *See id.* at 785–86 (arguing that the IRS attempted to "stack the deck" against the taxpayer).

147. *See id.* ("To be consistent, the analysis should either count all tax law effects or not count any of them.").

148. *See id.* at 781–82 (stating that because both elements were satisfied in this case, no decision was necessary).

149. *See id.* at 781 ("Other courts have said that business purpose and reasonable possibility of profit are merely factors to be considered in determining whether a transaction is a sham.").

C. The Federal Circuit: Salem Financial, Inc. v. United States

The Federal Circuit provides the first decision that declined to follow the holdings of the Fifth and Eighth Circuits.[150] In the case, Branch Banking & Trust Corporation (BB&T) challenged a judgment of the Court of Federal Claims on behalf of its subsidiary, Salem Financial, Inc.[151] The dispute over the refund arose from a complicated financial transaction known as a Structured Trust Advantaged Repackaged Securities (STARS) transaction.[152] Though the components of these transactions are complex, only a rudimentary understanding of their effect is necessary for this discussion.[153]

Initially, BB&T, a U.S. financial holding company, entered into a STARS transaction with Barclays Bank PLC, a United Kingdom company.[154] The transaction consisted of two

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150. *See* Salem Fin., Inc. v. United States, 786 F.3d 932, 944–51, 960 (Fed. Cir. 2015) (discussing in detail the Fifth and Eighth Circuit decisions and ultimately distinguishing the case before the court from these two prior decisions).

151. *See id.* at 936 (seeking to obtain a refund for "taxes, interest, and penalties" which the IRS disallowed—an assessment which the tax court subsequently upheld).

152. *See id.* (describing the transaction as a "means of enhancing investment yield for large, cash-rich corporations located in the United States by taking advantage of differences between the tax systems in the United States and in the United Kingdom").

153. The specific mechanics of STARS transactions are difficult to dissect. The inner workings of these transactions are outside of the scope of this Note and are themselves the topic of much scholarship. For detailed accounts on the nuts and bolts of STARS transactions, see, e.g., Bank of N.Y. Mellon v. Comm'r, 40 T.C. 15 (2013); James A. Beavers, *Tax Court Weighs In on STARS Transaction*, TAX ADVISER (Apr. 1, 2013), http://www.thetaxadviser.com/issues/2013/apr/taxtrends-april2013-story-01.html (last visited Feb. 9, 2017) (on file with the Washington and Lee Law Review); Richard M. Lipton, BNY *and* AIG*—Using Economic Substance to Attack Transactions the Courts Do Not Like*, 119 J. TAX'N 40 (2013) [hereinafter Lipton, BNY *and* AIG]; Richard M. Lipton, *The Stars Continue to Shine—Wells Fargo Prevails on Various Motions*, 122 J. TAX'N 64 (2015); Peter D. Mills & Peter E. Burt, *Will the Stars Align for the STARS Transactions?*, BLOOMBERG BNA (July 29, 2015), https://www.bna.com/stars-align-stars-n17179934045/ (last visited Feb. 9, 2017) (on file with the Washington and Lee Law Review).

154. *See Salem Fin., Inc.*, 786 F.3d at 936 (promoting the transaction, together with KPMG, as a "low cost" financing under which BB&T would obtain economic benefits from favorable tax treatment).

components—a trust and a loan.[155] BB&T created the trust and contributed a large amount of "income-generating assets."[156] BB&T then entered into a loan agreement that "consisted of a payment by Barclays of $1.5 billion in cash to the Trust in return for subscription to three classes of equity interests in the Trust."[157] Yet, even though Barclays held an equity interest in the trust, BB&T retained control over the trust at all times.[158] To create the cross-border element, BB&T appointed a U.K. trustee to manage the trust.[159] The income generated from the assets would be paid to the trust, which would withhold the U.K. taxes, followed by a temporary transfer to a Barclays account before being transferred directly back to the trust.[160] This resulted in "a substantial tax benefit for Barclays by allowing it to claim a 'trading loss deduction' under U.K. law."[161] BB&T's and Barclays's tax benefits also resulted from the so-called "Bx payments."[162] These payments "[were] set to be equal to 51 percent of the U.K. taxes paid by the Trust, which had been paid by BB&T and which resulted in the tax benefits obtained by Barclays."[163] Together, the transaction created substantial tax benefits for both companies.[164]

The Federal Circuit used a simplified example to illustrate the benefits of the transactions.[165] The court stated that "$22 for

155. *See id.* at 937 (describing the trust as the primary vehicle and the loan as the mechanism for achieving the tax benefits). The term "Bx payment" is a term created by BB&T.

156. *See id.* at 937, 951 (valuing the contributed assets at approximately $5.8 billion and noting that these assets in fact created "legitimate income").

157. *Id.* at 937.

158. *See id.* (noting that "Barclays was contractually obligated to sell" the $1.5 billion interest back to BB&T once the transactions concluded, which would be categorized as a loan).

159. *See id.* (explaining that the trustee's U.K. residence triggered the U.K. tax liability, which would ultimately lead to the foreign tax credit).

160. *See id.* (creating a "circular movement" of funds between the trust and Barclays).

161. *Id.*

162. *See id.* at 937–38 (describing the payments as another avenue through which BB&T and Barclays reduced their tax liability).

163. *Id.* at 938.

164. *See id.* (amounting, in total, "to foreign tax credits in the amount of $498,161,951.00").

165. *See id.* (framing the tax consequences in terms of "$100 of Trust

every $100 of Trust income was set aside for payment of the U.K. taxes, leaving the Trust with $78 after the U.K. tax payment," for which it would later receive a tax credit.[166] Moreover, because Barclays held an equity interest in the Trust, Barclays was also subject to U.K. taxation on the same income.[167] However, Barclays was able to offset the Trust's tax burden, resulting in an effective tax rate of $8 per every $100 of Trust income.[168]

The "circular movement" between the Trust and Barclays provided an additional tax benefit.[169] The result was that "Barclays' $8 U.K. tax liability was then completely offset by the $23.40 tax deduction, leaving Barclays with a net tax benefit of $15.40."[170] Barclays then added another $3.30 of tax benefits based on the Bx payments.[171] BB&T received a tax benefit by claiming a tax credit for the U.K. tax paid on the Trust income.[172] In total, "BB&T anticipated receiving approximately $44 million per year from the STARS Trust transaction in addition to the revenue generated by the assets themselves."[173] Yet, the success of the STARS transactions depended on the favorable assessment by the tax authorities.[174]

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income").

166. *See id.* (basing those figures on the twenty-two percent tax rate which the U.K. levied on the Trust income).

167. *See id.* (subjecting Barclays to a tax of $30 on every $100 based on the 30% U.K. corporate tax rate).

168. *See id.* (claiming an "imputation credit" for the $22 of tax already paid by the Trust under UK law).

169. *See id.* (moving the remaining $78 of income from the Trust to Barclays and back, resulting in a "trading loss" for Barclays for which it was able to claim a $23.40 deduction).

170. *Id.*

171. *See id.* ("The net benefit to Barclays, for every $100 in Trust income, was thus $7.70, based on U.K. tax credits and deductions (the net tax benefit of $15.40 minus the Bx payment of $11, plus the tax benefit of $3.30 attributable to the deduction for the Bx payment).").

172. *See id.* (explaining that BB&T would receive a dollar-for-dollar credit for the $22 of taxes paid to the UK, in addition to the $11 BB&T gained through the Bx payment).

173. *Id.*

174. *See id.* at 939 (acknowledging that both parties knew of these risks, and thus included additional agreements under which BB&T agreed to indemnify Barclays should the projected profits fail "to match the parties' expectations").

The Federal Circuit stated that to determine whether BB&T should receive the refund, the transaction required an analysis under the economic substance doctrine.[175] Thus, a cumulative inquiry was necessary, namely that the transaction must fulfill both the objective and the subjective prongs of the doctrine.[176] The court focused its analysis on the objective prong of the doctrine.[177] The court examined the economic reality of the transaction.[178] The inquiry focuses "on whether the taxpayer had a 'reasonable possibility of making a profit from the transaction.'"[179] The court in *Salem Financial, Inc. v. United States*[180] examined three questions in this regard, of which the first two provide the basis for the third.[181]

First, BB&T disputed the government's claim that the Bx payments were, in fact, rebates of the U.K. tax.[182] The court rejected BB&T's argument, stating that the payments were "not truly independent."[183] Second, BB&T argued that the Bx

175. *See id.* at 940 (agreeing with the Third and Eleventh Circuit that "economic substance is a prerequisite to the application of any Code provision allowing deductions" (citations omitted)).

176. *See id.* (arguing that in order to determine whether a transaction was genuine or a sham, "the court examines the economic reality and business purpose of the transaction" (citing Stobie Creek Invs. LLC v. United States, 608 F.3d 1366, 1375 (Fed. Cir. 2010)).

177. *Id.* at 943. Regarding the subjective prong, the court ultimately concluded that the transaction had no bona fide business purpose, because BB&T "knew that the transaction revolved solely around a tax benefit because Barclays represented the transactions as creating a benefit from the ability of both parties to obtain credits for the taxes paid in the Trust." *See id.* at 952 (referring to BB&T's chief financial officer's statement describing the expected benefit in terms of tax benefits).

178. *See id.* at 943 (framing the question of economic reality as "whether a particular transaction or set of transactions meaningfully altered the taxpayer's economic position, apart from their tax consequences" (citing Stobie Creek Invs. LLC v. United States, 608 F.3d 1366, 1375 (Fed. Cir. 2010))).

179. *Id.* (quoting Stobie Creek Invs. LLC v. United States, 608 F.3d 1366, 1376–77 (Fed. Cir. 2010)).

180. 786 F.3d 932 (Fed. Cir. 2015).

181. *Infra* notes 182–188 and accompanying text.

182. *See Salem Fin., Inc.*, 786 F.3d at 943 (claiming that because the payments were "independent of Barclays' actual receipt of any U.K. tax benefits," they should be treated as income).

183. *See id.* at 943–44 ("BB&T's ability to benefit economically from the Bx payments depended on Barclays' receipt of its expected tax benefits, which in turn depended on the Trust's U.K. tax payments.").

payments should nevertheless be treated as income.[184] The court agreed with BB&T, rejecting the government's argument that the payments were merely tax effects because the amounts were calculated through a tax-based formula.[185] Third, the government argued that even if the Bx payments were treated as income, BB&T did not generate any profit "absent the foreign tax credit because the Bx payments must be offset against the Trust's U.K. taxes."[186] Conversely, BB&T contended that the government erred in treating the U.K. taxes as an item of expense rather than income.[187] Ultimately, the Federal Circuit agreed with the government, stating that "a transaction's economic reality, and in particular its profit potential, [must be] independent of the expected tax benefits."[188]

The court's reasoning revolved primarily around BB&T's reliance on *Compaq* and *IES*.[189] Upon examining the facts and reasoning of those cases, the Federal Circuit expressly declined to follow those holdings.[190] Specifically, the court noted that "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."[191] Rather, transactions must have real economic

184. *See id.* at 944 (basing its argument on the seminal Supreme Court case, *Old Colony Trust Co. v. Commissioner*, 279 U.S. 716, 721, 729 (1929)).

185. *See id.* at 946 (arguing that the government provided no authority to support its claim and that the claim was at odds with the principles established in *Old Colony*).

186. *See id.* at 947 (claiming that the "[t]rust transaction produced a net loss and therefore lacked economic substance," because "for every $100 of income from the Trust assets, even if BB&T were credited with $11 income in the form of the Bx payment, that $11 would have to be offset against BB&T's $22 U.K. tax expense, which would yield a loss of $11").

187. *See id.* at 947–48 (relying primarily on the Fifth and Eighth Circuits' reasoning in *Compaq* and *IES*, namely that potential for economic profit must be determined based on gross profit).

188. *See id.* at 948–49 (ruling that "[t]he Trust transaction . . . is profitless before taking into account BB&T's expected foreign tax credits").

189. *See id.* at 947–51 (examining in detail the facts involved and the Fifth and Eighth Circuits' reasoning).

190. *See id.* at 948 (holding that the Fifth and Eighth Circuits' conclusion was incorrect and that the transactions at issue in those cases produced "no real economic benefit").

191. *See id.* (explaining that "all tax shelter transactions produce a gain for the taxpayer after the tax effects are taken into account" and that this is the

effects apart from both taxes paid and tax credits received.[192] Thus, the transactions had "no realistic prospect of producing a profit (apart from the effect of the foreign tax credits)."[193] This effectively meant that the transaction had no independent economic characteristics apart from the tax consequences.

D. Second Circuit: Bank of New York Mellon Corporation v. Commissioner

The Second Circuit issued another decision rejecting the Fifth and Eighth Circuit holdings nearly fifteen years later.[194] The case involved two consolidated appeals.[195] The facts of these cases are complex, but the essential information is as follows.[196]

In the first case on appeal, the American International Group (AIG) engaged in six cross-border transactions.[197] AIG established a special purpose vehicle (SPV) to facilitate the transactions.[198] Initially, AIG created and funded a foreign SPV.[199] Subsequently, "AIG . . . sold the SPV's preferred shares to a foreign lender bank and committed to repurchase the preferred shares on a specific future date at the original sale price."[200] This meant that the SPVs consisted primarily of a small contribution from AIG and

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primary reason why companies are willing to enter into such transactions at all).

192. *See id.* at 949 (ensuring such benefits only if "there is a genuine multi-party transaction" that has real business considerations (quoting Frank Lyon Co. v. United States, 435 U.S. 561, 583–84 (1978))).

193. *See id.* at 951 (agreeing with the trial court that "the income 'from BB&T's preexisting assets cycled through the STARS Trust was not [economic] profit from STARS'" (citations omitted)).

194. Bank of N.Y. Mellon Corp. v. Comm'r, 801 F.3d 104, 104 (2d Cir. 2015).

195. *See id.* at 107 (involving AIG in one case, and the Bank of New York Mellon in the other).

196. *Id.* For a detailed description of the two underlying cases, see, e.g., Lipton, BNY *and* AIG, *supra* note 153, at 41–46.

197. *See Bank of N.Y. Mellon Corp.*, 801 F.3d at 104 (appealing a denial of a tax refund of $306.1 million).

198. *See id.* at 108 (noting that the SPV "borrowed funds at economically favorable rates below [market] and invested the funds at rates above [market], ostensibly to make a profit").

199. *See id.* (intending the SPV "to hold and invest funds in a foreign country").

200. *Id.*

funds the foreign bank paid for the stock.[201] Finally, "[t]he SPV then used this capital to purchase investments, earning income for which the SPV paid taxes to the relevant foreign authority. The SPV then paid most of the net proceeds of this investment income to the foreign bank as dividends."[202]

Contrary to the finding of the lower court, AIG claimed the transactions had economic substance because AIG expected a pre-tax profit.[203] However, to generate a pre-tax profit, AIG ignored the foreign tax paid by the SPV and the value of AIG's foreign tax credit.[204]

In the second case, the Bank of New York Mellon (BNY) entered into a STARS transaction offered by Barclays.[205] To simplify the complicated STARS transaction, the Second Circuit provided the following illustration:

> The resulting tax benefits to both BNY and Barclays from STARS can be illustrated by tracing a hypothetical $100 of trust income through the distribution cycle . . . . Under U.K. tax law, Barclays—as owner of [a certain] class [of stock] . . . was deemed the owner of almost all of the trust income and taxed at the 30% U.K. corporate tax rate, obligating it to pay $30 in tax for every $100 of trust income ($100 x 30%). Barclays would reduce this tax bill, however, by claiming a credit for the 22% U.K. tax on the trust, which was paid by BNY. Barclays' tax liability for the trust income was thus only $8 ($30–$22). BNY, in turn, would claim a foreign tax credit in the United States for the full $22 it had paid in U.K. taxes on the trust's income.[206]

Based on these facts, the tax court disregarded the STARS transaction for tax purposes, considering foreign taxes paid as an

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201. *Id.*

202. *Id.*

203. *See id.* at 109 (noting that the profit was for the life of the transactions).

204. *See id.* ("[S]ubtracting only AIG's operating expenses and obligations to foreign banks.").

205. For a detailed description of this highly convoluted transaction, see generally Bank of N.Y. Mellon Corp. v. Comm'r, 140 T.C. 15 (2013).

206. Bank of N.Y. Mellon Corp. v. Comm'r, 801 F.3d 104, 111 (2d Cir. 2015) (citations omitted).

expense in determining the economic reality of the transactions.[207]

After describing the facts of these two cases, the Second Circuit set out the applicable law.[208] The court considered "1) whether the taxpayer had an objectively reasonable expectation of profit, apart from tax benefits, from the transaction; and 2) whether the taxpayer had a subjective non-tax business purpose in entering the transaction."[209] While the Court acknowledged that it was not bound by the Internal Revenue Code amendment mandating the evaluation of both prongs, it ultimately discussed both.[210]

Most of the court's analysis focuses on the objective prong of the economic substance test.[211] At the heart of the discussion was "[t]he question . . . [of] whether, for purposes of the economic substance doctrine, foreign taxes should be treated as costs when calculating pre-tax profit."[212] Ultimately, the Second Circuit decided to follow the Tax Court and *Salem*.[213] The Second Circuit quoted the Tax Court, stating that the foreign taxes cannot be observed in isolation: "Economically, foreign taxes are the same as any other transaction cost. And we cannot find any conclusive reason for treating them differently here, especially because . . . the foreign taxes giving rise to the foreign tax credits

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207. *See id.* at 112 (noting that the transaction also failed under the subjective prong).

208. *See id.* at 113–19 (stating that the economic substance doctrine applies to foreign tax credit regimes).

209. *Id.* at 115 (citing Gilman v. Comm'r, 933 F.2d 143, 147–48 (2d Cir. 1991)).

210. *See id.* at 114 (arguing that the court was not bound because the amendment was passed after the facts of the cases occurred).

211. *See id.* at 115–22 (discussing thoroughly the approaches of other courts in delineating its own test). The Second Circuit devoted very little of its opinion to the subjective prong. *See id.* at 119–23 (allocating only one paragraph to describing the standard and its application to the cases respectively). The Second Circuit agreed with the lower courts that the transactions were purely tax motivated, concluding that BNY's transactions "lacked a reasonable relationship" to any stated business purpose. *See id.* at 120–23 (describing additionally AIG's transactions as "tax driven" and "tax based").

212. *Id.* at 116.

213. *See id.* ("The purpose of calculating pre-tax profit is to discern, as a matter of law, whether a transaction meaningfully alters a taxpayer's economic position other than with respect to tax consequences.").

stemmed from economically meaningless activity . . . ."[214] In other words, the foreign taxes are intrinsically linked to credits they create—or, rather, the tax benefit the taxpayer is trying to achieve—and are thus taken into account as expenses for the calculation of pre-tax profits.

Not only did the Second Circuit agree with the lower court and the Federal Circuit, but it also discussed and subsequently declined to follow the Fifth and Eight Circuits.[215] The court ruled "foreign taxes are economic costs for purposes of the economic substance doctrine and thus should be deducted from profit *before* calculating pre-tax profit."[216] Based on this test, the court concluded that the transactions in dispute failed the objective prong.[217]

Based on these four cases, the circuits are split on one distinct issue: Should foreign income taxes paid be taken into account when calculating pre-tax profits for the purposes of the objective prong of the economic substance doctrine? The Fifth and Eighth Circuits take the position that foreign taxes should be included in calculating pre-tax profits.[218] Thus, the possibility for pre-tax profit was based on gross revenue, rather than net revenue.[219] They argued that to decline the taxpayer this interpretation was to "stack the deck" against him.[220]

The Federal and Second Circuit declined to follow this approach.[221] The Circuits concluded that foreign taxes are similar to any other transaction cost and should not be seen as "income" for the purposes of determining pre-tax profits.[222] Thus, a clear

214. *Id.* at 117.

215. *See id.* at 118 (concluding that it is appropriate to consider the effect of foreign taxes, but not the corresponding credit in assessing pre-tax profit).

216. *Id.* at 119.

217. *See id.* at 120–21 (noting that for AIG's foreign tax credit "far exceeded" the potential for an economic benefit and that BNY's transaction provided no "reasonable opportunity for economic profit").

218. *See supra* notes 110–149 and accompanying text (concluding that the transactions were bona fide).

219. *Supra* note 130 and accompanying text.

220. *See supra* note 146 and accompanying text (noting that either all, or none of the tax benefits should be considered).

221. *See supra* notes 190, 215 and accompanying text (determining that foreign taxes should be treated as expenses).

222. *See supra* note 214 and accompanying text (agreeing with the tax court

dichotomy exists in the application of the doctrine between the four circuits. This split brings uncertainty to the economic substance doctrine, and thus a solution is necessary, especially considering current and emerging cases on the issue.

IV. Litigation in Other Jurisdictions

A. A Case Study: The Recent First Circuit Decision: Santander Holdings USA, Inc. v. United States

While the recent First Circuit decision[223] would be adequately placed within Part III of this Note dealing with the circuit split, it provides a perfect case study when comparing it to the lower court's decision.[224] Specifically, as the First Circuit ultimately rejected the district court's ruling.[225] The cases are particularly intriguing because they provide insight into the arguments of both sides of the split as applied to the same STARS transaction.[226]

The factual circumstances of the cases are substantially similar to both *Salem* and *Bank of N.Y. Mellon Corp. v. United States*[227] (*BNY*), concerning a STARS transaction in which the taxpayer—in this case Santander Holdings Corp., formerly known as Sovereign[228]—entered into with Barclays Bank PLC in the UK.[229] The Internal Revenue Service disallowed the foreign

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that because foreign taxes were a prerequisite to the foreign tax credits, they should be excluded).

223. *See generally* Santander Holdings USA, Inc. v. United States, 844 F.3d 15 (1st Cir. 2016).

224. *See generally* Santander Holdings USA, Inc. v. United States, 144 F. Supp. 3d 239 (D. Mass. 2015), *rev'd*, 844 F.3d 15 (1st Cir. 2016).

225. *Compare Santander*, 144 F. Supp. 3d at 240–41 (rejecting the claim that foreign taxes paid are tax effects and that they should be included in calculating pre-tax revenue), *with Santander*, 844 F.3d at 21–26 (reversing the district court decision and agreeing with the analysis of the Federal and Second Circuit, namely that foreign income taxes paid should not be include in the calculation of pre-tax profits).

226. *Supra* notes 223–224 and accompanying text.

227. 801 F.3d 104, 117–18 (2d Cir. 2015).

228. *See Santander*, 844 F.3d at 17 (having acquired Sovereign, Santander became the plaintiff in this line of cases).

229. *See generally Santander*, 144 F. Supp. 3d at 240. At this point, it is not necessary to repeat the simplified structure of STARS transactions once again.

tax credit that resulted in "$234 million in [additional] federal income taxes, penalties, and interest . . . for the tax years 2003, 2004, and 2005."[230]

Beginning its analysis with the objective prong of the economic substance doctrine, the district court focused on "whether the 'Barclays payment' (also known as the '[B]x 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.'"[231] The court "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."[232]

The district court split its analysis into two sections: the loan portion of the STARS transactions and the trust portion of the STARS transactions.[233] In terms of the loan, the court concluded that even though the loan was above market rate, this did not mean it lacked economic substance.[234]

Turning to the trust transaction, the district court rejected the claim that the transaction lacked economic substance.[235] The court's reasoning relied primarily on the fact that the assets that Santander placed into the trust "were earning income and Sovereign was being taxed on that income before the STARS transaction."[236] Additionally, the court noted that Santander's

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For the essential components of STARS, see *supra* notes 152–174 and accompanying text.

230. *Santander,* 144 F. Supp. 3d at 240.

231. *Id.* at 241.

232. *See id.* (rejecting specifically the 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").

233. *Id.* at 241–44.

234. *See id.* at 241–42 ("[The loan] furnished the bank with capital to invest in its business that had to be paid back.").

235. *See id.* at 242 (following the same reasoning as the *IES* and *Compaq* courts, but noting that the tax payments, unlike the STARS transaction at issue here, were the result of arbitrage transactions).

236. *Id.*

contribution of assets to the trust did not have any economic effects on the income, but instead was purely a jurisdictional issue.[237] Specifically, the court rejected the government's claim that "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."[238]

The court's final point on the objective prong of the economic substance doctrine originated from the Fifth Circuit's reasoning in *Compaq*.[239] The court ruled that it would be stacking the deck against the taxpayer to agree with "the government's bootstrap position . . . that the tax payment should be included and the tax credit excluded because if that is done, the transaction appears to lack economic substance."[240]

The First Circuit did not share the district court's view on Santander's STARS transaction.[241] Focusing solely on the issue of the economic substance of the trust transaction, the First Circuit "agree[d] with the reasoning of the Federal Circuit opinion in *Salem* in rejecting the claims that the Trust transaction had economic substance . . . substantially rely[ing] on its analysis."[242] The court noted that it was not necessary to address the nature of the Bx payments, as the trust transaction had no reasonable prospect for profit without taking into account the expected foreign tax credits.[243] Specifically "[t]he 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

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237. *See id.* at 243 ("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.").

238. *Id.*

239. *See id.* (referring to the view that if courts view foreign taxes paid as expenses for the purposes of calculating pre-tax profits, they should also "consider the effect of the offsetting of U.S. foreign tax credit[s]").

240. *Id.*

241. *See* Santander Holdings USA, Inc. v. United States, 844 F.3d 15, 23–26 (1st Cir. 2016) (reversing the district court's decision and following the reasoning of *Salem* and *BNY*).

242. *Id.* at 19.

243. *See id.* at 23 (agreeing with the Federal Circuit that the STARS trust transactions were "shaped solely by tax-avoidance features" (quoting Salem Financial, Inc. v. United States, 786 F.3d 932, 942 (Fed. Cir. 2015))).

value in U.K. taxes."[244] Finally, the First Circuit addressed the district court's "stack the deck" argument, stating that the economic reality of a transaction does not depend on whether "the transactions produced a net gain to the taxpayer after taking both the foreign taxes and the foreign tax credit into account."[245] The court reasoned that taxpayers are only willing to enter into tax shelter transaction at all because they produce a benefit which taxpayers derive from the corresponding tax effects.[246]

The two preceding cases provide a perfect illustration for the need of a definitive resolution of the question of how foreign income taxes should be treated for the purpose of pre-tax profits. The district court's approach to the STARS transactions, and similarly the objective prong of the economic substance test, is fundamentally different to the alternative approach the First Circuit advances.[247] The district court's ruling that the trust transaction had economic substance because the underlying assets themselves were substantive is fundamentally flawed, as it disregards the altered use of the assets.[248] However, narrowing its focus to this limited aspect of the trust transaction, the court disregarded the other parts of the trust that solely created tax benefits.

This conceptual dichotomy illustrates the need for uniform application and clarification of the objective prong of the economic substance doctrine. This is especially true considering the recent district court cases under the jurisdiction of the Eighth Circuit.

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244. *Id.* at 24.

245. *Id.* at 26 (quoting Salem Financial, Inc. v. United States, 786 F.3d 932, 948 (Fed. Cir. 2015)).

246. *See id.* ("[B]ecause 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." (quoting Salem Financial, Inc. v. United States, 786 F.3d 932, 948 (Fed. Cir. 2015)).

247. *Compare supra* notes 231–240 and accompanying text, *with supra* notes 242–244 and accompanying text.

248. *See* Santander Holdings USA, Inc. v. United States, 144 F. Supp. 3d 239, 241–42 (D. Mass. 2015) (basing its argument on the fact that because the assets were part of substantive transactions before the contribution to the trust, they are therefore inevitably substantive under the trust as well).

B. Federal District Court of Minnesota: Wells Fargo & Co. v. United States

One of the most recent district court decision stems from the District Court of Minnesota in *Wells Fargo & Co. v. United States*,[249] under the jurisdiction of the Eighth Circuit. In *Wells Fargo*, the district court ruled on a motion for summary judgment, concluding that the STARS transaction at issue likely lacked economic substance.[250]

Like the transactions in *Salem*, *BNY*, and *Santander*, this case concerned the tax treatment of STARS transactions.[251] While the transactions in this case occurred between Wells Fargo and Barclays, the mechanics of the STARS transactions are virtually identical to the other STARS cases previously discussed.[252]

To review the STARS transaction, the district court, in substance, applied the economic substance doctrine, beginning with the objective inquiry.[253] As a preliminary matter, the court noted that when applying the economic substance doctrine "the transactions must be viewed as a whole"[254] and that Wells Fargo had the burden of proof to show that the transaction was "not a sham."[255]

Beginning with the objective prong of the economic substance doctrine, the court examined whether there was a reasonable

249. 143 F. Supp. 3d 827 (D. Minn. 2015).

250. *See id.* at 842–46 (relying primarily on the reasoning of the Federal and Second Circuits, agreeing that foreign income taxes should be treated as expenses for purposes of calculating pre-tax profits under the objective prong of the economic substance doctrine).

251. *Id.* at 830.

252. *See id.* at 830–34 (using the same example as the Federal Circuit in *Salem* to describe the elements of STARS); *supra* notes 154–174, 197–206 and accompanying text (referring to the STARS transactions at issue in the foregoing cases).

253. *See Wells Fargo*, 143 F. Supp. 3d at 834–46 (referring to the doctrine formally as the "sham-transaction doctrine," but relying chiefly on the courts in *Salem* and *BNY*, which applied the economic substance doctrine).

254. *Id.* at 834 (quoting IES Indus., Inc. v. United States, 253 F.3d 350, 356 (8th Cir. 2001)).

255. *See id.* (stating that claiming a tax deduction brings with it the burden of proving that the transaction has economic substance (citing Coltec Indus., Inc. v. United States, 454 F.3d 1340, 1355 (Fed. Cir. 2006))).

possibility of profit, focusing on the Bx payment first.[256] Wells Fargo argued that the Bx payment should be considered pretax income, because it was paid from one private party to another as compensation for services rendered.[257] Additionally, Wells Fargo argued that "Barclays' obligation to make the Bx payment was not contingent on Barclays' realization of tax benefits from the STARS transaction," and thus did not constitute a tax benefit or partial rebate.[258] While the court acknowledged some merit to the argument, it was ultimately not persuaded.[259] Relying on the Federal Circuit's reasoning in *Salem*, the court stated that "[t]he Bx payment . . . does not represent profit from any business activity; it is simply the means by which Barclays and BB&T shared the tax benefits of the Trust transaction."[260] In other words, "the Bx payment was not pretax revenue to Wells Fargo, but instead Wells Fargo's 'cut' of the tax benefits generated by the STARS transaction."[261]

One of Wells Fargo's additional arguments is that the STARS transactions, as a whole, had economic substance, because the loan portion of the STARS transactions generated tax-independent profits.[262] While the district court agreed with Wells Fargo that the loan itself likely resulted in pre-tax revenue, it only did so "when viewed in isolation."[263] Rather, the court declined to rule "as a matter of law that, because the loan had

256. *See id.* ("The characterization of the Bx payment is important to the resolution of this [issue]." (quoting Salem Financial, Inc. v. United States, 786 F.3d 932, 940 (Fed. Cir. 2015))).

257. *See id.* at 835 ("In Wells Fargo's view, the Bx payment that it received from Barclays is no different (for tax purposes) than, say, the payments that Barclays' attorneys or accountants received for their work on the STARS transaction.").

258. *Id.*

259. *See id.* at 835–36 (noting that, even though the Bx payment was consideration in exchange for Wells Fargo subjecting its assets to U.K. taxation, it "lacked any economic substance whatsoever").

260. *Id.* at 836.

261. *Id.* at 837.

262. *Id.* at 842 ("Wells Fargo argues, it had a reasonable expectation of pretax profit because Wells Fargo's anticipated (and actual) return on capital in the ordinary course of its banking operations during the five-year period of the loan exceeded 5.8 percent.").

263. *Id.* at 843.

economic substance, the loan imbued the entire STARS transaction with economic substance."[264]

Ultimately, the court concluded that Wells Fargo's motions for partial summary judgment should not be granted.[265]

Finally, it is important to note that the Federal and Second Circuits squarely addressed the issue of whether foreign taxes should be treated as expenses for calculating pre-tax profits. One explanation may be that while the District Court of Minnesota falls under the Eighth Circuit's jurisdiction, the court followed the Federal and Second Circuits' reasoning, putting it at odds with the Eighth Circuit on the issue. At the moment of writing this Note, the case has not completed trial. Thus, the issue might still become an element of the final judgment. Regardless, the case shows that the issue is far from settled.

V. Recommended Approach to the Objective Test of the Economic Substance Doctrine

From a financial standpoint, much is on the line for both taxpayers and the government.[266] The longer the circuit split exists, the longer the uncertainty exists for both parties. Thus, a resolution is essential, and in order to achieve the correct result, the split should be resolved in favor of the Federal and Second

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264. *Id.*

265. *See id.* at 853 ("[T]he Court has disagreed with the special master and has held that the characterization of the Bx payment must await trial."). The court came to the same conclusion regarding the subjective—business purpose—prong of the economic substance doctrine, denying Wells Fargo's motion for partial summary judgment that it had a non-tax business purpose. *See id.* at 845 ("[E]ven if the trust is considered to be part of the same transaction as the loan, and even if the jury finds that the integrated STARS transaction had economic substance, the jury might find that the integrated STARS transaction lacked a business purpose.").

266. *See* Bank of N.Y. Mellon Corp. v. United States, 801 F.3d 104, 104 (2d Cir. 2015) (concerning a combined tax deficiency of $521.1 million for *AIG* and *BNY*); Salem Fin., Inc. v. United States, 786 F.3d 932, 936 (Fed. Cir. 2015) (disallowing $498.1 million in foreign tax credits); Compaq Comput. Corp. v. Comm'r, 277 F.3d 778, 780 (5th Cir. 2001) (denying Compaq foreign tax credits in the amount of $3.4 million); IES Indus., Inc. v. United States, 253 F.3d 350 (8th Cir. 2001) ("[IES c]laimed a foreign tax credit on the ADR dividends for the amount of foreign tax withheld and paid to foreign governments, over $13.5 million.").

Circuits' approach. In other words, foreign taxes should be treated as expenses for the purposes of determining whether the taxpayer had a reasonable possibility of profit under the objective prong of the economic substance doctrine.

A. The Federal and Second Circuits' Approach Is Preferable

The U.S. foreign tax credit regime aims "to mitigate the evil of double taxation."[267] As foreign investment "can result in double taxation of a U.S. taxpayer's income earned abroad—by the country in which it was earned as well as the United States—Congress crafted the 'foreign tax credit' regime."[268] The regime served to alleviate the burden of doing business in foreign countries, and "was intended to facilitate business abroad and foreign trade."[269] However, it was not intended to provide the sole basis for profit to taxpayers.[270] Thus, when determining a reasonable expectation for profit, the only sensible approach is to exclude foreign tax credits from that determination, as they are tax benefits and do not have an economic character.

Under this approach, the next logical step is to treat foreign income taxes paid as expenses, rather than include them as

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267. Burnet v. Chi. Portrait Co., 285 U.S. 1, 7 (1932). For more information on foreign tax credits, see generally Bradley J. Tate, *Foreign Tax Credit Basics*, AM. BAR ASSOC., http://www.americanbar.org/groups/young_lawyers/publications/the_101_201_practice_series/foreign_tax_credit_basics.html (last visited Feb. 27, 2017) (on file with Washington and Lee Law Review); ZM Ishmurzina, *What Is Foreign Tax Credit? Ultimate Guide for US Taxpayers and Expats*, ARTIO PARTNERS, https://www.artiopartners.com/blog/foreign-tax-credit-guide-expats-abroad/ (last visited Feb. 27, 2017) (on file with the Washington and Lee Law Review); *Foreign Tax Credit*, INTERNAL REVENUE SERV., https://www.irs.gov/individuals/ international-taxpayers/foreign-tax-credit (last updated Dec. 16, 2016) (last visited Feb. 27, 2017) (on file with the Washington and Lee Law Review); *Foreign Tax Credit*, INVESTOPEDIA, http://www.investopedia.com/terms/f/foreign-tax-credit.asp (last visited Feb. 27, 2017) (on file with Washington and Lee Law Review).

268. *Bank of N.Y. Mellon Corp.*, 801 F.3d at 107.

269. *See id.* ("We would discourage men from going out after commerce and business in different countries . . . if we maintained this double taxation." (citing 56 Cong. Rec. App. 677 (1918) (statement of Rep. Kitchin))).

270. *See* Wells Fargo & Co. v. United States, 143 F. Supp. 3d 827, 836 (D. Minn. 2015) (emphasizing that tax credits are predicated by actual business, and require more than "exploiting differences among foreign tax codes" (quoting *Bank of N.Y. Mellon Corp.*, 801 F.3d at 113)).

profits. Foreign taxes are the very thing that give rise to foreign tax credits, and it is illogical to divorce them from tax credits for the purposes of calculating pre-tax profits.[271] If the objective prong of the economic substance doctrine is to provide a meaningful analysis into the business reality of a transaction, courts should disregard all tax considerations, including foreign taxes.[272]

Not treating foreign taxes as expenses renders the objective prong of the economic substance test toothless, as it would include the very item which gives rise to a tax benefit. The purpose of the economic substance analysis is "to provide courts a 'second look' to ensure that particular uses of tax benefits comply with Congress's purpose in creating that benefit."[273]

Including foreign taxes in the calculation of pre-tax profits would mean that the taxpayer would always obtain the corresponding tax benefit, provided the taxpayer contributed enough assets to generate a substantial liability. For example, the U.S. Court of Appeals for the Federal Circuit in *Salem* disallowed $498.1 million in foreign tax credits.[274] Thus, because foreign tax credits are a dollar-for-dollar reimbursement of foreign taxes paid, it can be inferred that the taxpayer in *Salem* paid $498.1 million in foreign taxes.[275] If the court had included these foreign taxes paid in its determination of whether the taxpayer had a reasonable expectation of profits, the taxpayer would inevitably fulfill this requirement, as this amount is—by any standard—substantial. This would defeat the purpose of the

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271. *See supra* notes 214–215 and accompanying text (concluding that it is appropriate to consider the effect of foreign taxes, but not the corresponding credit in assessing pre-tax profit).

272. *See* Altria Grp., Inc. v. United States, 658 F.3d 276, 284 (2d Cir. 2011) (noting that "even if a transaction's form matches the dictionary definitions of each term used in the statutory definition of the tax provision, it does not follow that Congress meant to cover such a transaction and allow it a tax benefit").

273. *Bank of N.Y. Mellon Corp.*, 801 F.3d at 113.

274. *Supra* note 266 and accompanying text.

275. *See* Ronald A. Worley, *The Indirect Foreign Tax Credit: A Policy Analysis of Section 902*, 13 INT'L TAX & BUS. LAW. 176, 178 (1996) ("A tax credit is a dollar for dollar reduction to taxes owed and, therefore, the foreign tax credit generally has the effect of treating foreign taxes (on foreign source income) as a 'down payment' on the taxpayers' U.S. tax liability.").

objective prong of the economic substance doctrine, as it incentivizes sham transactions such as STARS.[276]

The Fifth Circuit in *Compaq* concluded that "[t]o count [foreign taxes paid] only when they subtract from cash flow is to stack the deck against finding the transaction profitable."[277] This logic is not persuasive. The objective prong of the economic substance doctrine is not intended to be an easy way for the taxpayer to circumvent this necessarily rigorous inquiry.[278] Disregarding foreign taxes paid does not "stack the deck" against the taxpayer, it provides an effective deterrent against taxpayer abuses of the tax code.

Excluding foreign taxes in the determination of profits also provides the best approach going forward.[279] When it comes to transactions such as STARS, "[t]he endless ingenuity of taxpayers in attempting to avoid taxes means that there will be a first time for everything."[280] In other words, STARS transactions will not be method taxpayers use to gain an illegitimate advantage of tax benefits. This becomes particularly evident when comparing the fairly simple "dividend stripping" transactions at issue in *IES* and *Compaq* on the one hand, and the exceedingly complex STARS transactions in *Salem*, *BNY*, *Santander*, and *Wells Fargo*.[281] However, excluding foreign taxes from the determination of profits will act as a disincentive for

276. *See* Bank of N.Y. Mellon Corp. v. United States, 801 F.3d 104, 117 (2d Cir. 2015) ("Additionally, excluding the economic effect of foreign taxes from the pre-tax analysis would fundamentally undermine the point of the economic substance inquiry. That point is to remove the challenged tax benefit and evaluate whether the relevant transaction makes economic sense." (citations omitted)).

277. Compaq Comput. Corp. v. Comm'r, 277 F.3d 778, 785 (5th Cir. 2001).

278. *See Bank of N.Y. Mellon Corp.*, 801 F.3d at 118 ("The purpose of calculating pre-tax profit in this context is not to perform mere financial accounting, subtracting costs from revenue on a spreadsheet: It is to discern, as a matter of law, whether a transaction meaningfully alters a taxpayer's economic position other than with respect to tax consequences.").

279. *See id.* (noting the economic substance doctrine "was born out of necessity, as '[e]ven the smartest drafters of legislation and regulation cannot be expected to anticipate every [tax avoidance] device.'" (quoting ASA Investerings P'ship v. Comm'r, 201 F.3d 505, 513 (D.C. Cir. 2000))).

280. Wells Fargo & Co. v. United States, 143 F. Supp. 3d 827, 838 (D. Minn. 2015).

281. *Supra* notes 121–123, 152–171 and accompanying text.

taxpayers to engage in sham transactions, as taxpayers will be on notice that the IRS will only take their actual economic profits into account when determining the reasonable expectation for profits.

B. The Solution for Resolving the Split

The final question left to be answered is how the above suggestion—to treat foreign taxes paid as expenses for the purposes of determining the reasonable expectation of profits under the objective prong of the economic substance doctrine—should be implemented in practice. There are three ways in which this can occur. First, § 7701(o)(2)(B) of the Internal Revenue Code could be amended to require foreign taxes be treated as expenses, eliminating the need for the Secretary of the Treasury to promulgate regulations. Second, the Secretary of the Treasury could promulgate regulations, as § 7701(o)(2)(B) currently allows. Third, the Supreme Court of the United States could clarify the doctrine it initially created, providing flexibility for lower courts in applying the doctrine.

Currently, Congress mandates that "fees and other transaction expenses" are treated as expenses, while foreign taxes require the Secretary of the Treasury to promulgate regulations for foreign taxes to count as expenses in appropriate circumstances.[282] The most comprehensive solution would be to eliminate this distinction.

Congress could achieve this by merging foreign taxes into the first sentence of § 7701(o)(2)(B) and eliminating the second sentence.[283] Under this proposal, the new—single sentence—§ 7701(o)(2)(B) would read: "Fees, foreign taxes, and other transaction expenses shall be taken into account as expenses in determining pre-tax profit under subparagraph (A)." This would provide the most comprehensive solution and ensure uniform application throughout the courts.

An alternative approach to amending § 7701(o)(A)(B), is for the Secretary of the Treasury to—in fact—promulgate

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282. *Supra* notes 92–99 and accompanying text.

283. For the current two sentence structure of § 7701(o)(2)(B), see *supra* note 93 and accompanying text.

regulations. As of writing this Note, the Secretary has not promulgated any such regulations.[284]

While the Secretary has issued a regulation disallowing foreign tax credits for STARS transactions, the regulation does not address the specific issue of whether foreign taxes should be treated as expenses for the calculation of pre-tax profits.[285] Additionally, "the regulation does not purport to resolve the circuit splits presented here, which concern issues that affect transactions of any form, not just STARS."[286] Thus, the Secretary would need to issue regulations which do not merely apply to a specific transaction, but rather to certain types of transactions which contain common elements. While this approach would provide the flexibility for applying the objective prong of the economic substance doctrine, as it would be able to apply to a wide range of transactions, it would merely be a reactionary method of dealing with the ever developing area of sham transactions.

The third option is for the Supreme Court to grant certiorari, and resolve the circuit split. By means of a narrow holding, the Supreme Court should rule that foreign taxes are treated as expenses when determining the reasonable expectation of a pre-tax profit.

This approach would immediately resolve the circuit split and would provide uniformity in application between the courts. This option would also constitute an acceptable option going forward, deterring taxpayers from entering into sham transactions like STARS.

Of these three options, the best option is to amend § 7701(o)(A)(B). This option constitutes the most comprehensive solution, and would likely pre-empt any future variations transactions such as STARS. Additionally, it would create uniformity when calculating pre-tax profits for purposes of the objective prong of the economic substance doctrine.

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284. *Supra* note 103 and accompanying text.

285. *See* Petition for Writ of Certiorari, *supra* note 103, at 33 n.10 ("That regulation applies only prospectively; it does not apply to this case or any other pending STARS case.").

286. *Id.*

VI. Conclusion

The economic substance doctrine is in need of clarification. As one of the most long-standing tax doctrines, as well as the most prominent one today, a uniform application, particularly regarding its objective prong, is crucial. The circuit split between the Fifth and Eighth Circuits on the one hand, and the Federal, Second Circuit, and most recently the First Circuit, on the other, has led to considerable confusion and uncertainty for both taxpayers and tax authorities. Because of this confusion, hundreds of millions of dollars' worth of foreign tax credits are at stake.

While the legislative clarification of the economic substance doctrine provided some guidance on how to apply the doctrine, it did not provide any meaningful guidance regarding foreign income taxes. Thus, the stark dichotomy in treatment of foreign income taxes for the purposes of calculating pre-tax profits under the objective prong of the economic substance doctrine persists.

To eradicate this confusion, and to achieve the correct treatment of foreign income taxes, the Federal and Second Circuits' approach is preferable. To argue that treating foreign income taxes as expenses, and excluding foreign tax credits from the analysis of pre-tax profits is to "stack the deck" is illogical and leads to unintended results. It is impossible to divorce foreign income taxes from foreign income tax credits, as the former gives rise to the latter. Thus, they are both tax effects, which should have no bearing on the determination of actual pre-tax profit.

Excluding foreign income taxes from the calculation of pre-tax profits also provides the most consistent interpretation for future tax shelter transactions. The evolution from the "ex-dividend" transactions at issue in *IES* and *Compaq* to the highly complicated STARS transactions in *Salem*, *BNY*, and *Santander* make it reasonable to assume that in the future new, ingenious tax shelters will arise, seeking to take advantage of the tax code. However, by treating foreign income taxes as expenses for the purposes of calculating pre-tax profits, the courts will be able to quickly assess the true colors of a transaction.

As long as this circuit split exists, taxpayers and authorities will likely be engaged in lengthy legal battles of tax shelter cases. Treating foreign income taxes as expenses for pre-tax profit will provide an effective deterrent for taxpayers to engage in such tax arbitrage transactions in the first place.

Finally, the appropriate solution for resolving the circuit split is to amend § 7701(o)(A)(B). This would provide uniformity in application of the objective prong of the economic substance doctrine, and will significantly dampen the endless ingenuity of taxpayers in creating sham transactions. Amending § 7701(o)(A)(B) is the most appropriate solution going forward. In the context of these complex cross-border transactions, the economic substance doctrine is the gatekeeper to the legitimate allowance of foreign tax credits. Specifically, without an effective, and uniformly applied, objective prong and treatment of foreign taxes as expenses, courts are left with an ineffective deterrent to tax shelter shams. With hundreds of millions of dollars' worth of foreign tax credits on the line, it is crucial for courts to be able to distinguish between legitimate and illegitimate tax credits.