No. 15-572

In the Supreme Court of the United States

THE BANK OF NEW YORK MELLON CORPORATION AS SUCCESSOR-IN-INTEREST TO THE BANK OF NEW YORK COMPANY, INC., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

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

BRIEF FOR THE RESPONDENT IN OPPOSITION

DONALD B. VERRILLI, JR.
Solicitor General
Counsel of Record
CAROLINE D. CIRAOLO
Acting Assistant Attorney General
RICHARD FARBER
JUDITH A. HAGLEY
Attorneys
Department of Justice
Washington, D.C. 20530-0001
SupremeCtBriefs@usdoj.gov
(202) 514-2217

QUESTION PRESENTED

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

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-39a) is reported at 801 F.3d 104. The principal opinion of the Tax Court (Pet. App. 41a-83a) is reported at 140 T.C. 15. The supplemental opinion of the Tax Court (Pet. App. 85a-97a) is unreported but is available at 2013 WL 5311057.

JURISDICTION

The judgment of the court of appeals was entered on September 9, 2015. The petition for a writ of certiorari was filed on November 2, 2015. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. The United States taxes income earned abroad by U.S. citizens, residents, and domestic entities. 26 U.S.C. 61(a). Accordingly, when calculating its income

for U.S. tax purposes, a U.S. corporation must include income earned abroad, even though that income may also be subject to foreign tax. Domestic taxpayers, however, may claim a dollar-for-dollar tax credit (called the "foreign tax credit") for income taxes paid to another country, subject to numerous technical rules and other limitations. 26 U.S.C. 901-909. That credit serves "to prevent double taxation of taxpayers conducting business in the United States and abroad," Pet. App. 16a (emphasis omitted), and thereby "facilitate global commerce," *id.* at 26a.

Like other provisions of the Internal Revenue Code, foreign tax credits are subject to the "economic substance" doctrine. Pet. App. 14a-18a. Under that longstanding common-law principle, which was codified by Congress in 2010, "tax benefits * * * with respect to a transaction are not allowable if the transaction does not have economic substance or lacks a business purpose." 26 U.S.C. 7701(*o*)(5)(A). The doctrine rests on the presumption that Congress does not intend sham transactions to produce tax benefits, even if the transactions would otherwise trigger tax benefits under the pertinent statutory and regulatory provisions. See H.R. Rep. No. 443, 111th Cong., 2d Sess. 295 (2010); see also 12 *Mertens Law of Federal Income Taxation* § 45D:62 (2014) ("Entitlement to foreign tax credits is predicated on a valid transaction.").

2. Petitioner, a financial-services company, used a tax strategy called Structured Trust Advantaged Repackaged Securities (STARS) to generate $500 million in foreign tax credits. Pet. App. 9a-12a. The shelter was developed and promoted by Barclays Bank PLC, a U.K. financial-services company, and the accounting

firm KPMG, LLC. *Id.* at 9a. The Internal Revenue Service (IRS) ultimately concluded that the STARS transaction was a sham, and that the economic-substance doctrine therefore prohibited petitioner from claiming the foreign tax credits. *Id.* at 12a.

a. A taxpayer ordinarily would have no economic incentive to engage in a transaction solely to claim foreign tax credits because the credits are designed to create an economic wash in which each dollar of foreign tax paid offsets one dollar of U.S. tax owed. STARS, however, was designed to transform the foreign tax credit into economic profit, at the expense of the U.S. Treasury. STARS involved an arrangement whereby the U.S. taxpayer paid tax to the United Kingdom, claimed a foreign tax credit for that U.K. tax, and simultaneously recouped a substantial portion of its U.K. tax. Pet. App. 11a-12a, 33a-34a, 60a, 74a-76a. Instead of the typical one-to-one correlation of credits claimed to taxes paid, the taxpayer thus received one dollar in U.S. tax credits for substantially less than one dollar in foreign taxes that the taxpayer effectively paid.

The STARS shelter was extremely complex, but in general terms it worked as follows. The U.S. taxpayer diverted income from U.S. assets (such as loans to U.S. borrowers) into and out of a wholly owned Delaware trust that had a nominal U.K. trustee. Pet. App. 9a-10a, 44a-54a. Circulation of the income through the trust was purely a paper transaction, and no income was put at risk or deployed in any productive activities. *Id.* at 10a, 33a-34a, 56a-57a, 68a; C.A. App. 94-99, 115, 181-182, 209, 371, 724, 3356. Because the trustee was a U.K. resident, however, circulation of the income through the trust caused the income to become

subject to U.K. tax, despite the fact that the income never left the United States or the U.S. taxpayer's control. Pet. App. 9a-10a, 52a, 55a, 65a-68a, 81a. The taxpayer paid the trust's U.K. tax and claimed corresponding foreign tax credits on its U.S. return. *Id.* at 12a, 58a.

STARS, however, incorporated a mechanism that allowed the taxpayer to recoup a substantial portion of the U.K. tax, while retaining the full amount of the U.S. foreign tax credits. Barclays, the entity that marketed STARS, acquired at the outset a formal interest in the Delaware trust. Pet. App. 10a, 50a. Under U.K. law, that formal interest allowed Barclays to claim certain U.K. tax benefits, ultimately permitting Barclays to recover almost the full amount (in this case, 85 percent) of the taxes that the taxpayer had paid. *Id.* at 11a-12a, 56a. As part of the STARS strategy, Barclays agreed to return a significant percentage of that amount to the U.S. taxpayer, while keeping the rest as its "fee." *Id.* at 9a-12a; C.A. App. 313-314, 379, 1210, 1219.

As a result, the U.S. taxpayer would receive an effective refund (through Barclays) of 50% of its U.K. taxes, while claiming a foreign tax credit on its U.S. tax return as if it had paid 100% of those taxes. C.A. App. 1211; Pet. App. 12a, 34a. That benefit was achieved without putting any money at economic risk and without engaging in any productive business activities. Pet. App. 33a-34a, 66a-68a. The STARS strategy had an unlimited capacity to generate additional foreign tax credits, bounded only by the amount of income that a taxpayer could cycle through the

trust and the taxpayer's apprehension about arousing the suspicions of tax authorities. *Id.* at 52a-53a, 67a.[1]

b. Petitioner learned about the STARS tax shelter in June 2001, when KPMG contacted petitioner's tax director to determine whether it was interested in a "tax-advantaged transaction" that relied on foreign tax credits to generate a benefit for U.S. taxpayers. Pet. App. 43a; see C.A. App. 211, 229, 305-306, 362-363, 381-382, 1168. That benefit, according to KPMG, was predicated on the fact that "[b]oth banks [*i.e.*, Barclays and petitioner] claim tax credits for the same tax on income earned through a Delaware trust" and then share those tax credits. C.A. App. 1176, 1210-1211, 1215, 2180. After that conversation, petitioner understood that STARS transactions were "FTC [*i.e.*, foreign tax credit] revenue trades" from which it would "derive[ ] an economic return/tax benefit" through "foreign tax credits," with the "total tax benefit [being] split 50/50 between Barclays and [petition-

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[1] By way of illustration, assume that a U.S. taxpayer circulates its U.S. income through a STARS trust, which pays the United Kingdom $22 in tax for every $100 of trust income. Pet. App. 11a-12a. For every $22 paid in U.K. tax, the U.S. taxpayer claims a corresponding foreign tax credit, thereby reducing its U.S. tax liability by $22. *Ibid.* At the same time, Barclays recovers $18.70 from the United Kingdom as a result of the tax benefits generated by STARS, leaving the United Kingdom with $3.30. *Ibid.* Under the STARS agreement, Barclays splits the tax benefits with the U.S. taxpayer by returning $11 to the U.S. taxpayer, *id.* at 11a-12a, 34a, and keeping the rest as its "fee," *id.* at 12a; C.A. App. 313-314, 379, 1210, 1219. The reduction of U.S. taxes resulting from foreign tax credits thus primarily funds the STARS benefits received by the U.S. taxpayer and Barclays, with only a small portion going to the U.K. Treasury, all at the expense of the U.S. Treasury. Pet. App. 60a, 75a, 79a; C.A. App. 569-570, 664-665, 3177-3179, 3190, 3377-3378, 3433-3434.

er]." Pet. App. 43a; C.A. App. 1169, 1514. In November 2001, petitioner employed the STARS transaction to generate almost $500 million in foreign tax credits during the 2001-2006 tax years. Pet. App. 9a, 44a.

In petitioner's version of the scheme, the payments from Barclays were called "tax-spread" payments, and they equaled 50% of the U.K. taxes on the income that petitioner cycled through the Delaware trust. Pet. App. 10a, 72a; C.A. App. 1631, 1643. Petitioner described each tax-spread payment as a "rebate." Pet. App. 32a; C.A. App. 1511, 1525, 2530. Barclays acquired an interest in the trust for $1.5 billion, which, together with petitioner's obligation to repurchase that trust interest for $1.5 billion, petitioner treated as a "loan." Pet. App. 10a, 47a-50a. The "loan," which could be terminated by either Barclays or petitioner at any time with 5 to 30 days' notice, was not necessary for generating the foreign tax credits—indeed, as originally designed, STARS did not include the loan component. *Id.* at 54a, 64a; C.A. App. 265-266, 584, 600, 3183. But because the tax-spread rebate payments were used to offset the interest that petitioner owed on the loan, the loan served to mask the fact that the tax-spread rebate payments were effectively rebates of petitioner's U.K. taxes. Pet. App. 32a-34a, 72a-76a; C.A. App. 266-269, 600, 1176, 1237, 1511, 1525, 2530, 2593, 3183.

The loan also gave the transaction a patina of a legitimate business purpose even though, absent the tax-spread rebate payments' "offset," the loan's interest rate was far higher than the interest rate of petitioner's available alternative funding. Pet. App. 34a, 76a-77a, 79a. In marketing STARS to petitioner, KPMG suggested that petitioner could identify "low

cost funding" as the "business purpose" for STARS. C.A. App. 311, 377, 1176. In its own analysis of STARS, however, petitioner recognized that its actual "interest expense" on the loan was separate from the "Percentage of tax" it would receive from Barclays. *Id.* at 1211, 1631, 1643, 2593. Petitioner further understood that the amount of the tax-spread rebate payments had no relationship to the amount of the loan, but instead was based exclusively on the amount of tax that the trust was expected to pay to the United Kingdom. Pet. App. 72a; C.A. App. 112, 1179, 1209-1211; see note 3, *infra*.

c. In 2005, U.K. tax authorities notified the IRS about petitioner's STARS shelter, stating that the scheme had the "prime purpose of creating tax credit relief" and might involve "tax credit abuse." C.A. App. 28,604-28,605 (filed in *Salem Financial, Inc.* v. *United States*, No. 15-380). In 2007, the Treasury Department proposed regulations (which were finalized in 2011) that precluded taxpayers from claiming foreign tax credits from STARS and similar transactions after the regulations' effective date. Pet. App. 17a; see 72 Fed. Reg. 15,081 (Mar. 30, 2007) (entitled "Regulations on Transactions Designed to Artificially Generate Foreign Tax Credits"). The regulations' preamble indicated that the IRS would scrutinize tax benefits claimed in STARS transactions conducted before the regulations' effective date under various anti-abuse doctrines, including the "economic substance doctrine." Pet. App. 17a (quoting 72 Fed. Reg. at 15,084).

3. In its corporate tax returns for the years in which it had participated in STARS, petitioner claimed the full amount (approximately $500 million) of

foreign tax credits that the strategy was designed to produce.[2] The IRS disallowed petitioner's tax treatment of STARS on various grounds, including that the transaction lacked economic substance and had no valid business purpose. Pet. App. 59a. The IRS therefore denied the claimed tax benefits (which included both foreign tax credits and interest-expense deductions for the above-market interest on the loan). *Ibid.* Petitioner then filed a petition in the Tax Court, challenging the IRS's determinations.

After holding a bench trial and making extensive factual findings, the Tax Court determined that the IRS had properly denied the claimed foreign tax credits because the STARS transaction lacked economic substance. See Pet. App. 41a-83a. The Tax Court concluded that "the STARS transaction in essence * * * was an elaborate series of prearranged steps designed as a subterfuge for generating, monetizing and transferring the value of foreign tax credits among the STARS participants." *Id.* at 60a. The Tax Court based that conclusion on a number of findings, including that (i) "the STARS structure did not increase the profitability of the STARS assets in [any way]" but rather "reduced their profitability by adding substantial transaction costs," including foreign taxes, *id.* at 65a; (ii) "the activities or transactions that the STARS structure was used to engage in did not provide a reasonable opportunity for economic profit" because the transaction's "circular cashflows or offsetting payments had no non-tax economic effect," *id.* at 66a; and (iii) "the STARS structure" did not "per-

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[2] Only the 2001 and 2002 tax years are at issue in this case, but the subsequent years will be governed by the decision here as well. See Pet. 8 n.2.

form[] any significant banking, commercial or business function with respect to the loan," *id.* at 71a. The court explained that taxpayers are not entitled to tax benefits "from circular transfers the net result of which is effectively nothing." *Id.* at 67a.

In attempting to identify a valid business purpose for the shelter, petitioner argued that it had engaged in the STARS trust transaction in order to obtain a low-cost loan. Pet. App. 68a. The Tax Court found, however, that the "record does not support petitioner's claimed business purpose," and that petitioner's "true motivation was tax avoidance." *Id.* at 68a-69a. The court determined that the trust component of the shelter had no "reasonable relationship" to the loan and that, considered apart from the tax-spread rebate payments generated by the STARS trust structure, "the loan was not 'low cost'" in reality but rather was "significantly overpriced." *Id.* at 69a-77a.

Petitioner argued that, as reduced by the tax-spread rebate payments, the effective interest rate on the loan was a below-market rate. The Tax Court rejected that contention, explaining that those payments were not a true "component of interest" because they were unrelated to the amount of the loan. Pet. App. 58a, 72a-76a; see C.A. App. 112, 1179, 1209-1211, 1631, 1643, 2593. Rather, the court explained, those payments were "a device for monetizing and transferring the value of anticipated foreign tax credits" from the transaction by returning to petitioner "one-half the present value of the U.K. taxes the trust was expected to pay." Pet. App. 72a, 76a, 79a.[3] The

[3] The amount of the tax-spread rebate payments was set at 50 percent of the tax that petitioner was expected to pay to the United Kingdom, Pet. App. 10a, and therefore would have been the

Tax Court further held that, even if the tax-spread rebate payments were characterized as income rather than as a tax effect, they could not provide petitioner a net non-tax benefit because the payments were "more than offset by the additional transaction costs," including the foreign tax paid on the trust's income, that petitioner had incurred to obtain those payments. *Id.* at 77a n.15.[4]

The Tax Court initially held that petitioner was not entitled to deduct any of its STARS-related transaction costs, including the interest expense on the STARS loan. Pet. App. 81a-82a. On reconsideration, however, the court determined that petitioner could deduct the interest because, although the loan was "overpriced, the loan proceeds were available for use in petitioner's banking business." *Id.* at 93a.

4. Petitioner appealed, and the case was heard in tandem with a different taxpayer's appeal from a district-court decision raising similar questions about the appropriate treatment of foreign taxes in conduct-

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same whether the amount of the loan was $1, $100 billion, or something in between. Indeed, the artificial embedding of the tax-spread rebate payments in the loan generated an economically irrational "negative" bank-loan interest rate (Pet. 7) whereby Barclays purportedly paid petitioner to borrow Barclays' funds. Petitioner had hoped, for tax purposes, to avoid a "negative" interest rate because such a rate belied its characterization of the STARS transaction as a loan. Pet. App. 57a; C.A. App. 257, 600, 1321, 2671, 3358.

[4] The Tax Court additionally rejected petitioner's arguments that the trust arrangement had economic substance based on the income generated by petitioner's preexisting trust assets, petitioner's acquisition of the loan, or petitioner's use of the loan proceeds. Petitioner does not challenge those rulings in this Court. See Pet. 12 n.4.

ing an economic-substance analysis. See *American Int'l Grp., Inc.* v. *United States*, petition for cert. pending, No. 15-478 (filed Oct. 13, 2015). The court of appeals affirmed. Pet. App. 1a-39a.

The court of appeals first rejected the argument, raised by the taxpayer in *American International Group* but not raised by petitioner in the Tax Court and not "develop[ed]" by petitioner on appeal, Pet. App. 15a n.5, that a taxpayer may claim foreign tax credits even if the transaction giving rise to the foreign tax lacked economic substance. *Id.* at 14a-18a. The court explained that the economic-substance doctrine rests on the premise that Congress would not have intended tax benefits to flow from a transaction lacking economic substance or any real business purpose, "even if a transaction's form matches the dictionary definitions of each term used in the statutory definition of the tax provision." *Id.* at 15a (quoting *Altria Grp., Inc.* v. *United States*, 658 F.3d 276, 284 (2d Cir. 2011)). With respect to foreign tax credits specifically, the court determined that "Congress's intent * * * was to prevent double taxation of taxpayers conducting *business* in the United States and abroad," not "sham transactions built solely around tax arbitrage." *Id.* at 16a-17a (citing H.R. Rep. No. 1337, 83d Cong., 2d Sess. 76 (1954)). The court noted that its holding was consistent with Congress's 2010 codification of the economic-substance doctrine (although that codification is not applicable to the pre-2010 STARS transaction at issue here), which Congress enacted in recognition that "[a] strictly rule-based tax system cannot efficiently prescribe the appropriate outcome of every conceivable transaction that might be devised." *Id.* at 17a (brackets in origi-

nal) (quoting H.R. Rep. No. 443, 111th Cong., 2d Sess. 295 (2010)).

Turning to the transactions at issue in the consolidated appeals, the court of appeals explained that, under its precedents, "[i]n determining whether a transaction lacks 'economic substance,'" a court must consider both "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." Pet. App. 18a. The court of appeals emphasized that "the test is not a rigid two-step process," but rather "a flexible analysis where both prongs are factors to consider in the overall inquiry into a transaction's practical economic effects." *Ibid.* (internal quotation marks omitted).[5] The court further explained that the objective component of that analysis focuses in part on "whether the transaction 'offers a reasonable opportunity for economic profit, that is, profit exclusive of tax benefits.'" *Id.* at 20a (quoting *Gilman* v. *Commissioner*, 933 F.2d 143, 146 (2d Cir. 1991), cert. denied, 502 U.S. 1031 (1992)).

The court of appeals rejected petitioner's argument that, in determining whether a transaction would have been profitable absent the U.S. tax benefits, a court should also ignore foreign tax paid on the transaction. The court stated that "[o]ther circuits have taken disparate approaches" to the relevance of post-foreign-tax profitability. Pet. App. 20a; see *id.* at 20a-27a. The court agreed with the Federal Circuit's conclusion "that foreign taxes are economic costs that

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[5] The 2010 codification of the economic-substance doctrine requires the taxpayer to establish both factors. See 26 U.S.C. 7701(*o*)(1).

are properly deducted in assessing profitability for the purposes of economic substance," but that the "lack of post-foreign-tax profit d[oes] not conclusively establish that a transaction lacks objective economic substance." *Id.* at 20a-21a (citing *Salem Fin., Inc.* v. *United States*, 786 F.3d 932 (Fed. Cir. 2015), petition for cert. pending, No. 15-380 (filed Sept. 29, 2015)); see *id.* at 24a. The court explained that "[t]he purpose of calculating pre-tax profit" in an economic-substance analysis "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." *Id.* at 24a. The court concluded that whether a foreign transaction is profitable after foreign tax is paid is relevant to that inquiry. *Id.* at 25a. The court cautioned, however, that post-foreign-tax profitability is not the only relevant consideration, *id.* at 25a-27a, and that a proper analysis "look[s] to the overall economic effect of the transaction," *id.* at 27a, as well as to "whether the taxpayer ha[d] a legitimate, non-tax business purpose for entering into the transaction," *id.* at 28a.

Applying that understanding of the economic-substance doctrine, the court of appeals upheld the Tax Court's conclusion that the STARS trust lacked economic substance. Pet. App. 31a-35a. The court reiterated that "the objective economic substance analysis does not end at profit." *Id.* at 33a. For that reason, the court held, the fact that the STARS trust transaction had no potential for profit after foreign tax was not determinative, and the Tax Court had acted "appropriately" in "consider[ing] other aspects of the trust transaction to assess economic substance." *Ibid.* The court of appeals concluded that the Tax

Court's economic-substance determination was supported by numerous findings, including that the trust transaction (i) consisted of "circular cash flows[]" that had no real economic effect other than "generat[ing] tax benefits for [petitioner] and Barclays"; (ii) artificially triggered a foreign tax because the trust's "funds never left the United States[,] yet [petitioner] installed a nominal U.K. trustee precisely so the trust would be subject to U.K. taxation"; and (iii) "lacked a subjective business purpose beyond tax avoidance." *Id.* at 32a-35a. Based on the evidence adduced in the Tax Court, the court of appeals concluded that petitioner had failed to establish by a preponderance of the evidence that the STARS transaction was motivated by anything other than petitioner's desire to "obtain $2 of foreign tax credit for each $1 of expenditure." *Id.* at 34a. The court found the transaction to be inconsistent with Congress's purpose in establishing the foreign-tax-credit regime, because the transaction "fictionalize[d] the concept of international trade," *id.* at 26a, and did not involve any "real risk of double taxation," *id.* at 21a (internal quotation marks omitted; emphasis omitted); see *id.* at 33a.

The court of appeals rejected petitioner's argument that the STARS transaction should be held to have economic substance in light of the benefits provided by the tax-spread rebate payments (*i.e.*, the mechanism by which Barclays returned to petitioner half of the foreign tax paid). Pet. App. 32a-33a. The court found no error in the Tax Court's conclusion that the rebate payments should not be considered income for economic-substance purposes because those payments "serv[ed] as a device for monetizing and transferring the value of anticipated foreign tax credits generated

from routing income through the STARS structure." *Id.* at 32a (quoting *id.* at 76a). The court of appeals further held, in the alternative, that the transaction lacked a reasonable opportunity for economic profit "regardless of how the spread is characterized," because "the benefit of the spread was more than offset by the additional transaction costs," including the foreign taxes paid, that petitioner had "incurred to obtain the spread." *Id.* at 33a (citation omitted).

Finding no error in the remainder of the Tax Court's analysis, the court of appeals upheld the Tax Court's conclusion that petitioner could not lawfully claim foreign tax credits and related transaction-expense deductions based on the trust component of the STARS transaction. Pet. App. 39a. The court also upheld the Tax Court's determination that petitioner was entitled to interest deductions for the loan component of the STARS scheme. *Id.* at 35a-37a, 39a.

ARGUMENT

The court of appeals correctly held that the trust component of petitioner's STARS tax strategy lacked economic substance, and that petitioner therefore could not lawfully claim foreign tax credits based on that transaction, because petitioner did not engage in any productive business activities and lacked a business purpose. The court's conclusion does not conflict with any decision of this Court or another court of appeals. In light of Congress's 2010 codification of the economic-substance doctrine, which specifically addresses the treatment of foreign taxes, the question whether petitioner could properly claim tax credits under pre-2010 law also lacks prospective importance. Further review is not warranted.

1. The court of appeals correctly affirmed the Tax Court's conclusion that STARS is an economic sham and that petitioner therefore was not entitled to the tax benefits that the shelter produced. See Pet. App. 31a-35a.

Petitioner used the STARS shelter to claim foreign tax credits as if it had paid the full amount of foreign tax, even though petitioner had recouped approximately half of its foreign-tax payments through the tax-spread rebate payments. The amount of those rebate payments bore no relation to the amount of the loan that petitioner had employed to give STARS a veneer of a legitimate purpose. See Pet. App. 58a, 72a-76a. Rather, the rebate payments correlated directly with the amount of foreign tax that petitioner paid, enabling petitioner to claim approximately $2 in foreign tax credits for every $1 of out-of-pocket cost. That structure was directly contrary to the basic purpose of the foreign-tax-credit regime to offset U.S. tax with foreign taxes actually paid.

As the Tax Court explained after making extensive factual findings, Pet. App. 42a-59a, "[t]he STARS transaction in essence * * * was an elaborate series of prearranged steps designed as a subterfuge for generating, monetizing and transferring the value of foreign tax credits among the STARS participants." *Id.* at 60a. The Tax Court based that conclusion on a number of findings, including that (i) "the STARS structure did not increase the profitability of the STARS assets in [any way]," but rather "reduced their profitability by adding substantial transaction costs," *id.* at 65a; (ii) "the activities or transactions that the STARS structure was used to engage in did not provide a reasonable opportunity for economic

profit" because the transaction's "circular cashflows or offsetting payments had no non-tax economic effect," *id.* at 66a; and (iii) "the STARS structure" did not "perform[] any significant banking, commercial or business function with respect to the loan," *id.* at 71a.

Affirming the Tax Court's holding that the STARS trust lacked economic substance, the court of appeals concluded that the function of the scheme was to ensure that petitioner would be "reimbursed for half of its U.K. tax payments" while "simultaneously claim[ing] a foreign tax credit in the United States for the full payment amounts." Pet. App. 33a. The court further explained that the transaction's "circular cash flow strongly indicated that its main purpose was to generate tax benefits for [petitioner] and Barclays," *ibid.*, and that petitioner's "interest in STARS was entirely predicated on the tax benefits it involved," *id.* at 34a.

The decision below is consistent with the only other court of appeals decision that has applied economic-substance principles to the STARS tax shelter. See *Salem Fin., Inc.* v. *United States*, 786 F.3d 932 (Fed. Cir. 2015), petition for cert. pending, No. 15-380 (filed Sept. 29, 2015). There is no merit to petitioner's repeated contention (Pet. 2, 14, 25, 27) that the court of appeals' decision subjects it to "double taxation." Pet. App. 33a. The purpose and economic effect of STARS was that most of the U.K. tax paid by petitioner was recovered by Barclays, which then returned a substantial portion of that amount to petitioner through the tax-spread rebate payments. C.A. App. 314, 379, 1211, 1511, 1525, 2530. "[F]ar from risking double taxation, [petitioner] used an extremely convoluted

transaction structure to take maximum advantage of U.S. and U.K. tax benefits." Pet. App. 33a.

2. Petitioner objects (Pet. 15-23) to two aspects of the lower courts' multifaceted economic-substance analysis, framing each objection as a separate question presented. See Pet. i. Both objections are unfounded.

a. Petitioner contends that the court of appeals erred in relying on the fact that the STARS trust did not offer a reasonable opportunity for economic profit after foreign tax was paid as one consideration supporting its conclusion that the shelter was a sham. See Pet. App. 20a-27a, 32a, 65a n.9. That argument lacks merit.[6]

i. The economic-substance doctrine serves to distinguish legitimate business transactions from transactions that are "shaped solely by tax-avoidance features that have meaningless labels attached." *Frank Lyon Co.* v. *United States*, 435 U.S. 561, 584 (1978). For that reason, courts generally ask "whether the transaction 'offers a reasonable opportunity for economic profit, that is, profit exclusive of tax benefits.'" Pet. App. 20a (quoting *Gilman* v. *Commissioner*, 933 F.2d 143, 146 (2d Cir. 1991), cert. denied, 502 U.S. 1031 (1992)). In the context of the foreign-tax-credit regime, that inquiry should focus on whether the transaction is profitable after foreign tax is paid.

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[6] Two other petitions for writs of certiorari raising the same question (one of which seeks review of the same Second Circuit decision as the petition here) are currently pending. See *American Int'l Grp., Inc.*. v. *United States*, No. 15-478 (filed Oct. 13, 2015); *Salem Fin., Inc.* v. *United States*, No. 15-380 (filed Sept. 29, 2015).

Congress provides foreign tax credits to ensure a "uniformity of tax burden" between U.S. taxpayers engaged in legitimate business activities abroad and U.S. taxpayers engaged in domestic business activities. Pet. App. 16a (quoting H.R. Rep. No. 1337, 83d Cong., 2d Sess. 76 (1954)). Where foreign taxes and other costs of a taxpayer's putative foreign business overwhelm any potential for profit, that imbalance, at minimum, raises a serious concern that the transaction may be a sham. Legitimate businesses do not often engage in activities whose costs, inclusive of taxes, subsume any profit potential. To be sure, circumstances may arise in which such behavior would be rational even apart from its U.S. tax consequences. See Pet. App. 27a ("Transactions involving nascent technologies * * * often do not turn a profit in the early years unless tax benefits are accounted for.") (quoting *Salem Fin.*, 786 F.3d at 950). But the court of appeals accounted for that possibility by treating post-foreign-tax profitability as an important but not dispositive factor in the economic-substance analysis.

The court of appeals did not hold that the absence of post-foreign-tax profitability is determinative of the economic-substance question. See Pet. App. 27a. Rather, the court explicitly adopted the approach of the Federal Circuit in *Salem Financial*. See *id.* at 24a. Under that approach, the fact that "a taxpayer has incurred a large foreign tax expense that would render the transaction unprofitable absent the foreign tax credit" triggers "careful review of the transaction" to determine whether it "meaningfully alters the taxpayer's economic position (other than with regard to the tax consequences) and whether the transaction has a bona fide business purpose." *Salem Fin.*, 786

F.3d at 950; see Pet. App. 27a-28a. But as the court of appeals explained, the "objective economic substance inquiry * * * does not end at profit," Pet. App. 27a, because "[t]here is no simple device available to peel away the form of [a] transaction and to reveal its substance," *ibid.* (second set of brackets in original) (quoting *Frank Lyon*, 435 U.S. at 576); accord *Salem Fin.*, 786 F.3d at 949. Thus, "although inquiring into post-foreign-tax profit can be a useful tool for examining the economic reality of a foreign transaction * * * a transaction that fails the profit test [need not] necessarily be deemed a sham." *Salem Fin.*, 786 F.3d at 950. That contextual, transaction-specific analysis reflects a sound application of economic-substance principles.

Petitioner contends (Pet. 16-17) that this Court's 1929 decision in *Old Colony Trust* v. *Commissioner*, 279 U.S. 716, supports its position that post-foreign-tax profitability is never relevant to a transaction's economic substance. That decision, however, had nothing to do with the economic-substance doctrine or with foreign taxes. The Court in *Old Colony Trust* held that, when an employer pays U.S. tax owed by an employee, that payment constitutes income to the employee, just as if the employer had paid the same amount to the employee directly. *Id.* at 729. The question presented here is whether, when a cross-border transaction has no actual potential for post-foreign-tax profit, that fact is relevant to the question whether the transaction is a sham designed only to produce tax benefits. *Old Colony Trust* has no bearing on the proper resolution of that issue.

Petitioner reads *Old Colony Trust* to establish the much broader proposition that for all tax purposes,

including economic-substance analysis, "income is measured * * * by the gross pre-tax amount, not the net after-tax amount." Pet. 17. Petitioner identifies no specific language in *Old Colony Trust* that supports that reading. In any event, as explained above, the court of appeals did not treat "gross pre-tax" income (*ibid.*) as irrelevant to the economic-substance inquiry; it simply held that post-foreign-tax income is relevant as well. Nothing in *Old Colony Trust* casts doubt on that approach.

ii. As discussed, the only other court of appeals to consider the STARS shelter also has held that the trust transaction lacked economic substance. See *Salem Fin.*, *supra*. Petitioner contends (Pet. 18-19) that the court of appeals' holding that post-foreign-tax profitability can be relevant to an economic-substance analysis conflicts with the decisions in *Compaq Computer Corp. & Subsidiaries* v. *Commissioner*, 277 F.3d 778 (5th Cir. 2001) (*Compaq*), and *IES Industries, Inc.* v. *United States*, 253 F.3d 350 (8th Cir. 2001). Those decisions, however, concerned materially different transactions and do not squarely conflict with the holding below.

In *Compaq*, the U.S. taxpayer had purchased stock of publicly traded foreign corporations before a dividend record date. 277 F.3d at 779. The price of the stock reflected the impending dividends, minus the amount of the foreign taxes that would be withheld on those dividends. *Ibid.* The taxpayer then immediately sold the stock back to the original seller at a reduced price to reflect the fact that the original seller would not be entitled to dividends. *Id.* at 780. The taxpayer received the dividends minus the withheld foreign taxes. *Ibid.* On its U.S. tax return, the tax-

payer claimed capital losses and a foreign tax credit for the taxes that the foreign corporations had withheld from the dividends. *Ibid.* The Tax Court found that the dividend payment (as reduced by the withholding) was less than the loss on the sale, so that the transaction was not profitable overall before the U.S. tax benefits were claimed. *Id.* at 782. It therefore disallowed those benefits. *Id.* at 780.

The Fifth Circuit reversed, stating that "[t]o be consistent, the analysis should either count all tax law effects or not count any of them." 277 F.3d at 785. The court explained that, "[i]f the effects of the transaction are computed consistently," the taxpayer had "made both a pre-tax profit and an after-tax profit from the * * * transaction." *Id.* at 786. The Fifth Circuit then evaluated whether the "choice to engage in the * * * transaction was solely motivated by the tax consequences of the transaction," and concluded that it was not. *Id.* at 787. "Instead," the court explained, "the evidence show[ed] that [the taxpayer] actually and legitimately also sought the (pre-tax) * * * profit it would get from the * * * dividend," and that "[a]lthough * * * the parties attempted to minimize the risks incident to the transaction, those risks did exist and were not by any means insignificant." *Ibid.* The Fifth Circuit therefore concluded that "[t]he transaction was not a mere formality or artifice but occurred in a real market subject to real risks." *Id.* at 788. The Eighth Circuit in *IES Industries*, which considered a materially identical transaction, conducted a similar analysis and reached the same holding. See 253 F.3d at 354-356.

In the decision below, the court of appeals, citing *Compaq* and *IES Industries*, acknowledged that, "[i]n

factually different contexts, the Fifth and Eighth Circuits have taken a different approach" than did the court below. Pet. App. 21a-22a. But although the Fifth and Eighth Circuits treated post-foreign-tax profitability as irrelevant to the economic-substance analysis, neither court held that *pre*-foreign-tax profitability conclusively establishes the economic substance of the relevant transaction. Even after determining that the transactions at issue produced pre-foreign-tax profits, those courts considered other indicia of the transactions' economic effect and the taxpayers' intent. See *Compaq*, 277 F.3d at 786-787 ("[T]he evidence in the record does not show that Compaq's choice to engage in the ADR transaction was solely motivated by the tax consequences of the transaction."); *IES Indus.*, 253 F.3d at 356 ("We hold, considering all the facts and circumstances, that the ADR trades in which IES engaged did not, as a matter of law, lack business purpose or economic substance.").

Thus, although the Fifth and Eighth Circuits concluded that post-foreign-tax profitability is not a relevant consideration in the economic-substance analysis, their determinations that the transactions at issue had economic substance were ultimately attributable to those courts' determinations that the relevant transactions involved "a real risk of loss and an adequate non-tax business purpose." *Compaq*, 277 F.3d at 788; see *IES Indus.*, 253 F.3d at 354-356. In this case, by contrast, the court of appeals determined that "the circular cash flow demonstrates that [petitioner], far from risking double taxation," structured an "international tax arbitrage" scheme, and that petitioner's "singular motivation was the two-for-one tax benefit."

Pet. App. 26a, 33a-35a. Those features were not present in *Compaq* or *IES Industries*.

There is accordingly no sound basis to conclude that the Fifth and Eighth Circuits would have reached a different holding with respect to STARS than did the court below. While the Fifth and Eighth Circuits disregarded a particular consideration (the absence of post-foreign-tax profitability) that the court of appeals here viewed as warranting close scrutiny of the transaction, their decisions do not support petitioner's contention that STARS was a legitimate transaction for which it could claim foreign tax credits.

iii. The first question presented in this case lacks substantial prospective importance. As petitioner acknowledges (Pet. 33), when Congress codified the economic-substance doctrine in 2010, it specifically addressed the treatment of foreign taxes in the economic-substance analysis. Section 7701(*o*)(2)(B) provides that the Secretary of the Treasury "shall issue regulations requiring foreign taxes to be treated as expenses in determining pre-tax profit in appropriate cases." That provision reflects Congress's unambiguous rejection, with respect to transactions entered into after March 30, 2010 (the codification's effective date), of petitioner's view that foreign taxes should never be treated as expenses for purposes of economic-substance analysis. Although the Secretary has thus far proceeded case by case rather than through regulation, see I.R.S. Notice 2010-62, 2010-40 I.R.B. 411-412, Section 7701(*o*)(2)(B) reflects Congress's evident view that the profitability of a transaction after foreign taxes are imposed can be relevant to the economic-substance inquiry. The question whether the same approach is appropriate with respect to

pre-codification transactions is of no substantial continuing importance.

The 2010 codification also enumerated the requirements for a transaction to be deemed to have economic substance, one of which is that "the transaction changes in a meaningful way (*apart from Federal income tax effects*) the taxpayer's economic position." 26 U.S.C. 7701(*o*)(1)(A) (emphasis added). That language further supports the view that only U.S. tax consequences, not foreign-tax consequences, should be excluded when determining whether a transaction had economic substance. Although Congress intended to codify the preexisting common-law doctrine, 26 U.S.C. 7701(*o*)(5)(A), Congress's understanding of that doctrine as reflected in the 2010 codification will be highly relevant in resolving economic-substance disputes going forward. Because the transaction at issue here preceded the 2010 codification's effective date (and thus would provide the Court no opportunity to apply and construe the codification), and because it is unclear whether any disagreement among the circuits will persist in cases that are governed by that codification, further review is not warranted.[7]

Petitioner asserts (Pet. 24-25) that the Federal and Second Circuits' treatment of foreign taxes as an expense under the economic-substance doctrine has generated "uncertainty" for "cross-border transac-

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[7] Even apart from Congress's 2010 codification of the economic-substance doctrine, the tax benefits generated by the transaction at issue in *Compaq* and *IES Industries* have been separately eliminated, see 26 U.S.C. 901(k); *IES Indus.*, 253 F.3d at 356 n.5 (noting legislative amendment), as have those generated by STARS, as petitioner acknowledges (Pet. 33 n.10), see 26 C.F.R. 1.901-2(e)(5)(iv).

tions" and will "impede foreign investment." That argument, however, misconstrues the courts of appeals' decisions in this case and in *Salem Financial*, which were limited to sham transactions that "fictionalize[d] the concept of international trade," Pet. App. 26a (internal quotation marks omitted), and "involv[ed] no commerce or bona fide business abroad and ha[d] no purpose other than to obtain foreign and domestic tax benefits," *Salem Fin.*, 786 F.3d at 954. In any event, to the extent that some uncertainty concerning the parameters of the economic-substance doctrine exists, this Court could not effectively clarify the applicable law going forward by resolving a case, like this one, that involves a pre-2010 transaction. See p. 25, *supra*.

Petitioner also argues (Pet. 31) that the correct resolution of this case (and others like it) is important because the case "involves hundreds of millions of dollars in tax liability." But given the features of STARS discussed above, the transaction would lack economic substance, and petitioner would not ultimately receive the tax credits it seeks, even if the transaction's post-foreign-tax unprofitability were treated as irrelevant to the economic-substance inquiry. Indeed, the relatively large amount of tax at stake results directly from the STARS shelter's capacity to produce essentially unlimited tax benefits having no relation to actual economic risk or productive business activity. See pp. 4-5, *supra*.

b. Petitioner challenges (Pet. 20-23) the court of appeals' holding that the tax-spread rebate payments should not be treated as income for purposes of the economic-substance analysis, framing that issue as its second question presented (Pet. i). Petitioner argues

that the court's conclusion conflicts with *Old Colony Trust*'s holding that a third party's payment of a taxpayer's tax constitutes taxable income to the taxpayer.

That question is not properly presented at the current stage of this case. Although the court of appeals held that the tax-spread rebate payments should not be treated as income for purposes of economic-substance analysis (departing from *Salem Financial* in that respect, see 786 F.3d at 946), it also held in the alternative that, even if the payments were characterized as income, the STARS shelter would still lack any potential for profit because those payments were more than offset by the other transaction costs, including foreign taxes. See Pet. App. 32a-33a. Indeed, the Federal Circuit in *Salem Financial* reached the same bottom-line holding that the STARS transaction lacked economic substance, despite the court's conclusion that the rebate payments (there called "Bx payments") should be characterized as income. See 786 F.3d at 946-955. Because the court of appeals' resolution of the second question presented was not essential to that court's disposition of the case, further review of that question is not warranted.

In any event, petitioner misunderstands the court of appeals' determination with respect to the tax-spread rebate payments. The court did not disregard those payments "because the spread 'monetiz[ed] and transferr[ed]' *Barclays' U.K. tax treatment* to [petitioner]," as petitioner contends. Pet. 29 (quoting Pet. App. 32a) (alteration in original) (emphasis added). Rather, the court disregarded the payments because they "monetiz[ed] and transferr[ed] the value of *anticipated foreign tax credits*." Pet. App. 32a (emphasis added). Thus, the tax-spread rebate payments re-

flected *both* parties' tax benefits and ultimately were funded by petitioner's U.S. foreign tax credits, as the courts below concluded. See *id.* at 9a, 12a, 26a, 75a n.14, 76a, 79a; C.A. App. 569-570, 588, 3178-3179, 3186, 3190, 3377-3378; cf. *Salem Fin.*, 786 F.3d at 951 (observing that Barclays' tax benefits were "all at the expense of the U.S. Treasury"). In characterizing STARS as involving only the sharing of U.K. tax benefits, petitioner ignores the transaction's economic reality, which petitioner well understood when it internally characterized the transaction as an "FTC [foreign tax credit] revenue trade[]." C.A. App. 1169.

The court of appeals' determination that the tax-spread rebate payments were not income for economic-substance purposes does not conflict with *Old Colony Trust*'s conclusion that an employer's payment of its employee's U.S. income tax was taxable income to the employee. The court below did not address the question whether a third party's reimbursement to petitioner for petitioner's tax obligation in a genuine business transaction would constitute taxable income. Rather, the court held that the U.S. tax savings embodied in the rebate payments should not be considered in analyzing the STARS transaction's profitability as part of the overall economic-substance analysis. See Pet. App. 32a. Because *Old Colony Trust* did not involve the economic-substance doctrine, the Court's opinion does not cast doubt on the court of appeals' analysis and ultimate holding.

3. Petitioner obliquely suggests (Pet. 30) that the economic-substance doctrine should not apply to the foreign-tax-credit regime. As the court of appeals explained, petitioner did not raise that argument in the Tax Court or sufficiently develop it on appeal.

Pet. App. 15a n.5. In addition, petitioner does not present it as a separate question presented in its certiorari petition. See Pet. i. That issue therefore is not properly before the Court in this case. See Sup. Ct. R. 14.1(a).

In any event, the court of appeals correctly rejected petitioner's argument in disposing of the consolidated appeal in *American International Group*. Pet. App. 14a-18a; see generally Br. in Opp. at 19-24, *Salem Fin.*, *supra* (No. 15-380). This Court has long understood the economic-substance doctrine to reflect the premise that Congress would not have intended sham transactions to produce tax benefits *even if* the transactions technically comply with the statutory and regulatory provisions that authorize such benefits. See *Knetsch* v. *United States*, 364 U.S. 361, 365-366 (1960); *Gregory* v. *Helvering*, 293 U.S. 465, 467-470 (1935); see also *Frank Lyon*, 435 U.S. at 583-584. The courts of appeals likewise have consistently applied the economic-substance doctrine to reject tax shelters that technically complied with applicable tax rules but lacked economic substance. *E.g.*, *WFC Holdings Corp.* v. *United States*, 728 F.3d 736, 742-743 (8th Cir. 2013), cert. denied, 134 S. Ct. 2724 (2014); *Sala* v. *United States*, 613 F.3d 1249, 1253-1254 (10th Cir. 2010), cert. denied, 132 S. Ct. 91 (2011); *Dow Chem. Co.* v. *United States*, 435 F.3d 594, 599 (6th Cir. 2006), cert. denied, 549 U.S. 1205 (2007); *Winn-Dixie Stores, Inc. & Subsidiaries* v. *Commissioner*, 254 F.3d 1313, 1315-1316 (11th Cir. 2001) (per curiam), cert. denied, 535 U.S. 986 (2002); *ACM P'ship* v. *Commissioner*, 157 F.3d 231, 245-246 (3d Cir. 1998), cert. denied, 526 U.S. 1017 (1999).

The text and history of the 2010 codification reflect the same understanding. See 26 U.S.C. 7701(*o*)(5)(A) (defining the term "economic substance doctrine" to mean "the common law doctrine under which tax benefits under subtitle A with respect to a transaction are not allowable if the transaction does not have economic substance or lacks a business purpose"); H.R. Rep. No. 443, 111th Cong., 2d Sess. 295 (2010) (explaining that, because a "strictly rule-based tax system cannot efficiently prescribe the appropriate outcome of every conceivable transaction that might be devised," "many courts have long recognized the need to supplement tax rules with anti-tax-avoidance standards, such as the economic substance doctrine, in order to assure the Congressional purpose is achieved"). Petitioner's suggestion that the doctrine does not apply to sham transactions designed to produce foreign tax credits therefore lacks merit.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

DONALD B. VERRILLI, JR.
Solicitor General
CAROLINE D. CIRAOLO
Acting Assistant Attorney General
RICHARD FARBER
JUDITH A. HAGLEY
Attorneys

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