University of Dayton Law Review

Volume 42 | Number 2 Article 3

12-1-2017

Star Wars: Application of the Economic Substance Doctrine to Foreign Tax Credits, and What the Future Holds

Rebecca Rosenberg
Ohio Northern University

STARS WARS: APPLICATION OF THE ECONOMIC SUBSTANCE DOCTRINE TO FOREIGN TAX CREDITS, AND WHAT THE FUTURE HOLDS

Rebecca Rosenberg[*] *© 2016*

[*] Rebecca Rosenberg is an Assistant Professor of Law at Pettit College of Law at Ohio Northern University. She holds an LL.M. in taxation (with honors) from Georgetown Law Center, a J.D. (*cum laude*) from Harvard Law School, and an A.B. (*magna cum laude*) from Bryn Mawr College (with high honors in psychology).

I. OVERVIEW

Several recent foreign tax credit cases[1] provide a good opportunity to consider the economic substance doctrine (a judicial doctrine that allows courts to disallow all of the federal income tax consequences of a transaction that is beyond "the thing which the statute intended").[2] This article uses the STARS[3] cases (regarding the application of the economic substance doctrine to a specific foreign tax credit transaction) as a means to analyze several current issues under the economic substance doctrine, to discuss the possible future adaptations of such doctrine (especially in light of its recent codification), and to consider the other weapons the government might be able use to challenge problematic foreign tax credit transactions in the future. These issues are important because the economic substance doctrine plays a key role as an emergency back-up that allows the government to challenge arguably inappropriate claims of tax benefits. In addition, the circuits are currently split (after the STARS cases) on one important issue regarding the

---

[1] A brief summary of the STARS cases' holdings appears in the Appendix.

[2] *See* Gregory v. Helvering, 293 U.S. 465, 469 (1935).

[3] STARS is an acronym for Structured Trust Advantaged Repackaged Securities.

doctrine's application.[4]

The foreign tax credit is a credit against U.S. federal income tax for the amount of foreign tax paid or accrued (or deemed paid) by the taxpayer.[5] The credit is only allowed if its many statutory and regulatory requirements are met. Four recent cases on the STARS transactions have applied the economic substance doctrine to disallow foreign tax credits for foreign taxes that technically met the requirements of the Internal Revenue Code and its regulations.[6] Three of such cases have been addressed by appellate courts (*BNY Mellon II*, *Salem II*, and *Santander III*). The Supreme Court has denied *certiorari* in all three of such cases.[7]

The STARS fact pattern in each case, although very complex, essentially had the same effect as buying a Groupon: the taxpayer spent X for the ability to claim a U.S. foreign tax credit worth approximately 2X, but without (according to the government) any useful business activity. Getting the Groupon effect (foreign tax credits for approximately half their cost) was arguably the only purpose of the transaction. Before the foreign tax credit, costs from each STARS transaction (if the foreign taxes are treated as a cost)

---

[4] The circuit split is a conflict between the STARS appellate cases and previous appellate decisions in *Compaq Computer Corp. v. Commissioner* and *IES Industries, Inc. v. United States*. The latter two cases involved different transactions than the STARS cases, but addressed some of the same issues about the interaction between foreign tax credits and the economic substance doctrine. *See* Compaq Computer Corp. v. Comm'r, 277 F.3d 778, 788 (5th Cir. 2001) (*Compaq*); IES Indus., Inc. v. United States, 253 F.3d 350, 353–56 (8th Cir. 2001) (*IES*).

[5] *See* 26 U.S.C. §§ 901, 960. *See also* former 26 U.S.C. §902, *repealed by* An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018 (Tax Cuts and Jobs Act), Pub. L. No. 115-97, 131 Stat. 2054 (2017). Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986 (Code) and the accompanying Treasury Regulations.

[6] *See* Bank of N.Y. Mellon Corp. v. Comm'r, 140 T.C. 15 (2013) (*BNY Mellon I*), *modified*, 106 T.C.M. (CCH) 367 (2013), *aff'd by* 801 F.3d 104 (2d Cir. 2015) (*BNY Mellon II*), *cert. denied sub nom.* 136 S. Ct. 1375 (2016); Salem Fin., Inc. v. United States, 112 Fed. Cl. 543 (2013) (*Salem I*), *aff'd in part, rev'd in part* 786 F.3d 932 (Fed. Cir. 2015) (*Salem II*), *cert. denied* 136 S. Ct. 1366 (2016) (Salem Financial was the successor in interest to BB&T, and the *Salem I* and *Salem II* courts sometimes refer to the taxpayer as BB&T.); Santander Holdings USA, Inc. v. United States, 977 F. Supp. 2d 46 (D. MA. 2013) (*Santander I*), Santander Holdings USA, Inc. v. United States, 144 F. Supp. 3d 239 (D. MA. 2015) (*Santander II*), *rev'd by* Santander Holdings USA, Inc. v. United States, 844 F.3d 15 (1st Cir. 2016) (*Santander III*), *cert. denied* 137 S.Ct. 2295 (2017) (Santander Holdings USA, Inc. was the successor in interest for Sovereign Bancorp.); Wells Fargo & Co. v. United States, 143 F. Supp. 3d 827 (D. MN. 2015) (*Wells Fargo I*), Wells Fargo & Co. v. United States, No. 09-CV-2764, 2017 U.S. Dist. LEXIS 80401, 2017-1 U.S. Tax Cas. (CCH) P50,235 (D. MN. May 24, 2017) (*Wells Fargo II*), appeal docketed, No. 17-3578, No. 17-3676 (8th Cir. November 24, 2017), *see also* Wells Fargo & Co. v. United States, 2014 U.S. Dist. Lexis 99111 (D. MN. 2014) (report of the special master), Wells Fargo & Co. v. U.S., 2013 U.S. Dist. Lexis 131374 (D. MN. 2013) (earlier report of the special master), Wells Fargo & Co. v. U.S., 2017 U.S. Dist. Lexis 174595 (D. MN. 2017) (entry of final judgment). After this article was written, proceedings continued in the *Wells Fargo* case at the District Court level, as Wells Fargo requested a new judgement or a new jury trial on the grounds that (among other arguments) the Bx payment was not income and, even if the foreign taxes were not creditable, they could be deducted. Wells Fargo & Co. v. United States, Civ. No. 09-cv-02764-PJS-TNL (D. MN, October 24, 2017). The District Court denied this motion. Wells Fargo & Co. v. United States, Civ. No. 09-cv-02764-PJS-TNL (D. MN, February 5, 2018). Similarly, the taxpayer in *Santander* argued, in summary judgement proceedings at the District Court level (after its appeal was decided by the First Circuit), that it should not be subject to penalties and that it should be able to deduct the disputed foreign taxes. Santander Holdings USA, Inc. v. United States, No. 1:09-cv-11043 (D. MA. August 25, 2017). At the time of publication, such District Court proceedings are still ongoing in the *Santander* case.

[7] *See supra* note 6.

were roughly double the gross income from the transaction, leading to a net loss. But the foreign tax credits made the transaction worthwhile for the taxpayer.

The government used an economic substance argument to challenge foreign tax credits (and interest deductions) claimed in connection with the STARS transactions. The economic substance doctrine conceptually rests on the question of "whether what was done [by the taxpayer, in order to claim a tax benefit,] . . . was the thing which the statute intended."[8] In the case of foreign tax credits, Congress intended to allow taxpayers to choose a location for their business activities without being unduly influenced by duplicative U.S. and foreign tax on the same foreign source income.[9] The credit was not intended to cause meaningless transactions like the STARS trusts and their circular cash flows.

The economic substance doctrine generally implements its analysis (of consistency with Congressional intent) by considering two factors—an analysis of the transaction's objective potential for profit and an examination of the taxpayer's subjective business purpose—although various circuits describe the analysis slightly differently. In applying the objective profit prong of the economic substance test, courts have debated whether foreign taxes should be treated as a cost in determining whether the transaction has sufficient profit relative to tax benefits.

This article argues below that foreign taxes are correctly treated as a cost in computing profit under the economic substance doctrine, even if the taxpayer does not bear the economic burden of such foreign taxes. However, one of the STARS trial courts, and two circuit courts that earlier considered non-STARS fact patterns, did not treat foreign taxes as a cost in computing profit for these purposes. If foreign taxes are not treated as a cost, it is easier for taxpayers to claim that they expected a profit (even if expected foreign taxes were higher than expected income). This makes applying the economic substance test to foreign tax credit fact patterns harder but not impossible. It essentially places more pressure than usual on the other part of the economic substance analysis, the subjective test.

The economic substance doctrine is an important back-up plan for the government, and allows the government to challenge tax benefits that Congress did not intend, even if no legislative or regulatory rule technically bars such benefits. Practically speaking, the economic substance doctrine is especially useful for the government because the Treasury and the Internal Revenue Service (IRS) cannot issue rules fast enough to keep up with clever

---

[8] *See* Gregory v. Helvering, 293 U.S. 465, 469 (1935).
[9] *See infra* note 35.

tax advisors' tax planning.[10] In essence, the government is engaged in a perpetual game of catch-up (closing the barn door with notices and regulations after the tax abuse "horse" has moved on to other pastures). The STARS transactions nicely illustrate this point: the IRS issued regulations[11] to address such transactions after the transactions had occurred, so that the regulations can deter or address future STARS-like transactions. But the regulations are not retroactive, so the economic substance doctrine was one of the few approaches available to challenge the pre-regulation STARS transactions themselves.

The STARS cases have drawn a lot of attention, even though regulations have already been issued to cover such fact patterns.[12] These cases are still highly relevant because their holdings about the economic substance doctrine may affect future economic substance cases (not just those about the foreign tax credit), beyond these specific STARS fact patterns.

The STARS cases were decided without regard to section 7701(o) of the Internal Revenue Code, because the STARS transactions took place before that section's effective date (even though the cases were decided after section 7701(o)'s enactment). These cases thus provide a good backdrop for discussing the impact that section 7701(o) may have on the judicial doctrine of economic substance in the future, by demonstrating the flexibility that courts had in pre-7701(o) cases that they may not have for later years.

The economic substance doctrine is inherently challenging for taxpayers to predict and for the IRS and Treasury to apply, because it requires weighing and balancing, and is often not susceptible to a clear, predictable, mechanical application, even though the doctrine is valuable as a backstop

---

[10] *See* ASA Investerings P'ship v. Comm'r, 201 F.3d 505, 513 (D.C. Cir. 2000) ("Even the smartest drafters of legislation and regulation cannot be expected to anticipate every device."); Santander III, 844 F.3d 15, 21 n.7 (1st Cir. 2016) (explaining that the economic substance doctrine is necessary because "The endless ingenuity of taxpayers in attempting to avoid taxes means that there will be a first time for everything . . . and the economic substance test guards against abuse of loopholes that Congress and the IRS have not anticipated." (Internal citation omitted)).

[11] *See* Treas. Reg. §1.901-2(e)(5)(iv) (2016) (colloquially known as the "foreign tax credit generator" regulations).

[12] Technically, the IRS could still apply the economic substance doctrine to a transaction described in the foreign tax credit generator regulations, even after those regulations take effect. *See id.* The regulations will likely be a more appealing approach for the IRS (for transactions after they take effect), because their detailed, mechanical rules are easier to apply (with fewer gray areas) than the judicial doctrine. But the results of applying the economic substance doctrine are harsher and broader than the consequences of applying the regulations, so it is conceivable that the IRS might, in some egregious cases, seek to apply the judicial doctrine even if the regulations also apply. The regulations, if applicable, cause foreign taxes to become non-creditable (but arguably deductible), while the economic substance doctrine (if applied to find an economic sham) would cause the foreign taxes to be neither creditable nor deductible and generally would cause all other aspects of the attacked transaction to also be ignored for federal income tax purposes. Taxpayers might potentially argue that the regulations preempt the application of the economic substance doctrine, in the same way that Congressional intent (expressed in a statute) can foreclose the doctrine's application. *See, e.g.*, Horn v. Comm'r, 968 F.2d 1229, 1236 (D.C. Cir. 1992) (*Horn*). But this argument requires an equivalence between statutes and regulations, which seems unpersuasive. Therefore, taxpayers appear unlikely to succeed in arguing that the IRS cannot assert economic substance where regulations also apply.

and a response to taxpayers' evolving strategies and fact patterns. The difficulties in applying the economic substance doctrine in a predictable manner may make alternative responses (*e.g.*, by means of IRS guidance) appealing.

This article considers why the STARS transactions were so problematic: given all of the inaccuracies in the foreign tax credit rules, why are these transactions seen as troublesome, when other transactions are acceptable? The article analyzes how the economic substance doctrine ideally should be applied to such fact patterns, and to variations that may occur in the future. It also discusses possible future shifts in the application of the economic substance doctrine, especially after the enactment of section 7701(o) of the Code, which codifies the economic substance doctrine. These possible shifts could include greater future emphasis on a subjective business purpose analysis that has historically received relatively less attention in court opinions.

Lastly, the article discusses possible future approaches (legislative or regulatory) that the government might take to clarify the economic substance doctrine,[13] alter existing regulatory or legislative rules to address transactions in which lack of economic burden coincides with lack of real business activity, or establish new rules to deter such transactions. The STARS cases are a good opportunity to think about what kind of guidance (legislative, regulatory, or judicial), in addition to the existing foreign tax generator regulations,[14] might be able to address these kinds of transactions prospectively in order to deter them.

II. BACKGROUND

A. *Brief Overview of the Economic Substance Doctrine*

The economic substance doctrine is a long-standing judicial doctrine that generally disallows all of the U.S. federal income tax consequences (income, deductions, credits, etc.) of a transaction that is found to lack economic substance. A transaction lacking economic substance (and therefore disregarded for U.S. tax purposes) is referred to as an "economic sham." The fundamental inquiry, in determining whether a transaction has economic substance, is whether the challenged tax benefit (deduction, credit, or etc.) is within the intent of the statute that creates such benefit. As the Supreme Court has described it, "the question for determination [when assessing whether a party is entitled to particular tax benefit] is 'whether what was done, apart from the tax motive, was the thing which the statute

[13] Regulatory action is possible because the IRS can potentially issue guidance under section 7701(o) regarding the economic substance doctrine. *See* 26 U.S.C. § 7701(o) (2016).

[14] *See* Treas. Reg. § 1.901-2(e)(5)(iv).

intended.'"[15]

Answering this question is generally accomplished by examining first whether the transaction was reasonably expected to generate a profit or to cause a change in objective economic circumstances (the "objective analysis" or "objective prong")[16] and second whether the taxpayer had a subjective business purpose (the "subjective analysis," "business purpose test," or "subjective prong"). Some circuits required that a transaction meet both the objective and subjective tests in order to be respected as having economic substance.[17] This is known as the "conjunctive test." Other circuits held that a transaction that met either the objective profit analysis or the subjective business purpose test would be respected.[18] This is called the "disjunctive test." Still other circuits announced that they would not use a rigid two-prong analysis, but would instead apply a more flexible analysis that nonetheless included the elements of the objective profit test and subjective business purpose test.[19]

In many cases, these three types of formulations (conjunctive test, disjunctive test, and flexible analysis including objective economic effects and business purpose) yielded the same results. Some opinions decided that they had no need to choose between these various approaches if they found that a transaction met both prongs of the test (and presumably the same lack of distinction between the tests would apply if a transaction failed both prongs).[20] But occasionally the type of test made a difference to the economic substance finding. For example, a transaction could fail the objective test but pass the subjective business purpose test, or vice versa.[21] Such a transaction

---

[15] Knetsch v. United States, 364 U.S. 361, 365 (1960) (quoting Gregory v. Helvering, 293 U.S. 465, 469 (1935)).

[16] The objective prong is also sometimes called, confusingly, the "economic substance" prong or test, as compared with the business purpose portion of the test. *See, e.g.*, Compaq, 277 F.3d 778, 783 (5th Cir. 2001); Rice's Toyota World, Inc. v. Comm'r, 752 F.2d 89, 91 (4th Cir. 1985); I.R.S. Notice 2010-62, 2010-2 C.B. 411.

[17] *See, e.g.*, Dow Chem. Co. v. United States, 435 F.3d 594, 599 (6th Cir. 2006); Klamath Strategic Inv. Fund v. United States, 568 F.3d 537, 544 (5th Cir. 2009).

[18] *See, e.g.*, Rice's Toyota World, Inc. v. Comm'r, 752 F.2d 89, 91 (4th Cir. 1985); Horn v. Comm'r, 968 F.2d 1229, 1237-38 (D.C. Cir. 1992).

[19] *See, e.g.*, ACM P'ship v. Comm'r, 157 F.3d 231, 247 (3d Cir. 1998) (explaining that "The inquiry into whether the taxpayer's transactions had sufficient economic substance to be respected for tax purposes turns on both the 'objective economic substance of the transactions' and the 'subjective business motivation' behind them. . . . 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." Citations omitted.); Sacks v. Comm'r, 69 F.3d 982, 988 (9th Cir. 1995) (stating that "the consideration of business purpose and economic substance are simply more precise factors to consider in the application of this court's traditional sham analysis; that is, whether the transaction had any practical economic effects other than the creation of income tax losses."); James v. Comm'r, 899 F.2d 905, 908-09 (10th Cir. 1990); *Wells Fargo II*, No. 09-CV-2764 (D. MN. May 24, 2017) at 6.

[20] *See, e.g.*, IES, 253 F.3d 350, 354–55 (8th Cir. 2001); Compaq, 277 F.3d 778, 781–82 (5th Cir. 2001).

[21] *See, e.g.*, Cherin v. Comm'r, 89 T.C. 986, 992-93 (1987) (*Cherin*) (finding that the transaction failed the objective prong and declining to make a finding on subjective business purpose, because the court applied a disjunctive test). In a converse example, the *Wells Fargo* jury produced a rare result: it found

would be respected as having economic substance in a circuit applying the disjunctive test, but not in a circuit applying the conjunctive test (and the result under the flexible test is harder to predict).

Of the circuits deciding the STARS cases, the Second Circuit in *BNY Mellon II* says that it does not apply a rigid two-prong test to determine the economic substance of a transaction. Instead, (before section 7701(o)) it uses a "'flexible' analysis where both prongs are factors to consider in the overall inquiry into a transaction's practical economic effects"[22] but "neither factor [objective or subjective] is dispositive . . . ."[23] In *Salem II*, the Federal Circuit says that its approach to the economic substance test is consistent with section 7701(o)'s approach, discussed below, which is the conjunctive test.[24] *Santander I* and *III* applied a variant of the disjunctive test, stating that First Circuit precedent appears not to require analysis of business purpose if the objective prong is satisfied.[25] In fact, the First Circuit in *Santander III* stated that it preferred to examine only the objective prong.[26] The *Wells Fargo II* court applied a flexible analysis, because it decided that the Eighth Circuit was likely to choose that approach to the economic substance test.[27] The

---

that the loan had profit potential but no business purpose. This combination of findings squarely raises the issue of whether a transaction with such divergent findings has economic substance (before the effective date of section 7701(o)). The *Wells Fargo II* court decided that the Eighth Circuit was "likely to treat the objective and subjective components . . . as two factors in a single flexible analysis. . . ." *Wells Fargo II*, No. 09-CV-2764 at 6. Although interesting, this issue (of whether the Eighth Circuit applies the disjunctive test or another variant, and how transactions having profit potential but not business purpose are treated) has limited precedential value, because section 7701(o) requires the conjunctive test for transactions occurring after its effective date. The *Wells Fargo* court held that the loan passed the economic substance test. *Id.*

[22] BNY Mellon II, 801 F.3d 104, 115 (2d Cir. 2015).

[23] *Id.* at 125 n.6.

[24] *See* Salem II, 786 F.3d 932, 943 n.4 (Fed. Cir. 2015), *cert. denied* 136 S. Ct. 1366 (2016).

[25] The *Santander I* court indicated that meeting the objective prong alone was enough to meet the economic substance test, and implied that business purpose also could be taken into account. *Santander I* stated that:

> It is clear that cases dealing with the economic substance question *always* assess the objective economic reality of the transaction to determine whether it is in actuality a legitimate or a "sham" transaction. *Sometimes* the cases also assess the taxpayer's subjective purpose or motivation, and they often give that assessment different degrees of significance in their ultimate judgment. . . . where it found that the objective assessment established that the transaction *lacked* economic substance independent of tax considerations, the [First Ciruit] court did say that a subjective inquiry may be dispensed with.

Santander I, 977 F. Supp. 2d 46, 53–54 (D. MA. 2013) (citation omitted) (emphasis in the original). The First Circuit, however, went a step further in *Santander III*, stating that:

> This court has been particularly wary of inquiring into the subjective motivations of taxpayers: "[U]nless Congress makes it abundantly clear, we do not think tax consequences should be dependent upon the discovery of a purpose, or a state of mind, whether it be elaborate or simple."

Santander III, 844 F.3d 15, 22 (1st Cir. 2016) (citation omitted). Note that such an approach will not be possible after section 7701(o), discussed below, takes effect.

[26] *Santander III*, 844 F.3d 15 at 22.

[27] *Wells Fargo II*, No. 09-CV-2764 at 6. *Wells Fargo I* states, however, that the Eighth Circuit follows the Fourth Circuit's formulation from *Rice's Toyota*, which appears to be the disjunctive test: "Under that test, a transaction is a sham that should be disregarded for tax purposes if (1) it lacks economic substance because no real potential for profit exists apart from tax benefits *and* (2) it was not motivated by any economic purpose outside of tax considerations." Wells Fargo I, 143 F. Supp. 3d 827, 834 (2015) (emphasis

STARS courts' disparate descriptions of the economic substance test, while they all nonetheless analyze both the objective profit potential and subjective business purpose, are typical of the economic substance case law as a whole: despite differently worded descriptions, the courts tend to analyze the same elements.

In 2010, Congress enacted section 7701(o) of the Internal Revenue Code of 1986, to require the use of the conjunctive test in every circuit. Section 7701(o) provides that when the economic substance doctrine is "relevant," which the statute does not define, a transaction will be treated as having economic substance only if it "changes in a meaningful way . . . the taxpayer's economic position" *and* the taxpayer has a "substantial" subjective business purpose.[28] Profit can be used to meet the objective or subjective prong only if reasonably expected profit is at least substantial in relation to the expected tax benefits.[29]

Under the case law, the first step in an economic substance analysis is defining the arrangement – the transaction or set of related transactions - to which the profit and business purpose concepts are to be applied. Defining the tested arrangement is important because it affects how much profit, and what business purposes, can be taken into account in the taxpayer's favor.[30] Taxpayers sometimes attempt to group a more conventional, profitable transaction (like a loan) together with the more controversial transaction whose tax benefits are challenged by the government. For example, the STARS taxpayers argued that the trust arrangement and the loan in the STARS transaction should be tested as one arrangement (in order to argue that profit and business purpose attributed to the loan could be taken into account), while the government contended that the loan and the trust structure should be tested separately. Courts tend to define the tested arrangement as the set of transactions that created the challenged tax benefit, as distinguished from other transactions (or parts of transactions) that were not necessary to generate the challenged tax benefit.[31]

---

added) (describing the test from Rice's Toyota World, Inc. v. Comm'r, 752 F.2d 89, 91–92 (4th Cir. 1985)). This test, as articulated by *Wells Fargo I*, requires that a transaction fail both prongs before it can be treated as a sham, *i.e.* the taxpayer only needs to win one prong (the disjunctive test). *IES* cites this test as the Eighth Circuit's position, but then says that it has no need to decide whether this is a disjunctive test, because it finds that the taxpayer in *IES* meets both prongs. IES, 253 F.3d 350, 353-54 (8th Cir. 2001). *See also* Wells Fargo II, No. 09-CV-2764 (D. MN. May 24, 2017) at 2 (Citing WFC Holdings Corp. v. United States, 728 F.3d 736, 744 (8th Cir. 2013) ("this court has not yet adopted a particular approach to the sham transaction test")).

[28] 26 U.S.C. § 7701(o)(1)(A), (B) (2016).

[29] *Id.* § 7701(o)(2)(A).

[30] *See* David P. Hariton, *The Frame Game: How Defining the 'Transaction' Decides the Case*, 63 TAX LAW. 1, 1 (2009); *see also* Bret Wells, *Economic Substance Doctrine: How Codification Changes Decided Cases*, 10 FLA. TAX REV. 411, 419 (2010) (discussing the impact of section 7701(o) on the determination of the transaction to be tested under the economic substance doctrine).

[31] The *Salem I* court described this analysis as follows:

> The transaction to be analyzed is the one that gave rise to the alleged tax benefit . . . "even if it is part of a larger set of transactions or steps," Bank of New York, 140

For example, if the challenged tax benefits are losses or depreciation deductions, a loan incurred by the taxpayer may be treated as a separate arrangement from the actions that led to such losses or depreciation deductions, on the theory that the loan was not necessary to generate such amounts. On the one hand, such an approach prevents the taxpayer from using the loan to bolster its claims of profit or business purpose. On the other hand, it tends to protect interest deductions from the loan from being disallowed under the economic substance doctrine, due to their connection with the challenged transaction. Loans have frequently been the subject of debate as to whether they should be aggregated with, or bifurcated from, other elements of a multi-step transaction.[32] This issue regarding loans also arises in the STARS transactions.

In particular situations, there is also a potential argument that the economic substance doctrine does not apply to the specific kind of tax benefit (*e.g.*, to deductions for a particular item), because Congress has preempted the field. This can occur where Congress clearly intended to allow tax benefits for transactions that would fail the economic substance test.[33]

B. Brief Overview of Foreign Tax Credits

The foreign tax credit is a credit against U.S. federal income tax for the taxpayer's foreign taxes paid or accrued.[34] That credit, however, is subject to many, many complex rules and requirements. The foreign tax credit was enacted in 1918 in order to reduce the impact of the imposition of U.S. and foreign tax on the same item of income (known as double taxation).[35] More

---

> T.C. at 33 (citing, *inter alia*, Nicole Rose Corp. v. Comm'r, 320 F.3d 282, 284 (2d Cir. 2002). "Stated another way, the requirements of the economic substance doctrine are not avoided simply by coupling a routine transaction with a transaction lacking economic substance. A contrary application would undermine the flexibility and efficacy of the economic substance doctrine." Id. (citation omitted); see also Coltec, 454 F.3d at 1356 (observing that a taxpayer cannot show a non-tax business purpose "simply by showing some factual connection . . . to an otherwise legitimate transaction") (quoting Basic Inc. v. United States, 212 Ct. Cl. 399, 409, 549 F.2d 740 (1977)). The first step in the economic substance inquiry is to identify the transaction to be analyzed. The Government urges that the Trust and the Loan are economically distinct . . . .

Salem I, 112 Fed. Cl. 543, 584 (2013) (second alteration in original).

[32] *See, e.g.*, Rice's Toyota World, Inc. v. Comm'r, 752 F.2d 89, 91 (4th Cir. 1985).

[33] *See, e.g.*, Horn v. Comm'r, 968 F.2d 1229, 1236 (D.C. Cir. 1992) (suggesting that Congress clearly intended to allow deductions for commodities dealers for the types of straddle transactions at issue in that case, and therefore, the economic substance doctrine did not apply even if the transactions were solely tax motivated). *Contra* Gardner v. Comm'r, 954 F.2d 836, 839 (2d Cir. 1992) (reaching the opposite conclusion regarding application of the doctrine, and disregarding the transaction as an economic sham, under the same statute as *Horn*).

[34] *See generally* 26 U.S.C. § 901 (2016).

[35] *See Salem I* (and citations therein), describing the purpose of the foreign tax credit as follows:

> As courts consistently have recognized, the purpose of the foreign tax credit is to allow taxpayers to avoid double taxation on foreign income, and thus to "neutralize the effect of U.S. tax on the business decision of where to conduct business activities most productively." Bank of New York, 140 T.C. at 46; see also United States v. Goodyear Tire & Rubber Co., 493 U.S. 132, 139, 110 S. Ct. 462, 197 L. Ed. 2d 449

specifically, it was intended to allow U.S. taxpayers to make business decisions about whether to conduct business activities in the U.S. or, instead, in foreign countries, without having such location decisions overly influenced by the risk of paying both U.S. and foreign tax on the same income.[36]

For example, assume that a U.S. taxpayer earns $100 of income that is taxed both in the U.S. (at a rate of 35%) and in country X (at a rate of 30%). Further assume that the country X tax qualifies as a creditable tax (which is itself an analysis subject to many detailed rules), and that the taxpayer meets the requirements of the "foreign tax credit limitation fraction" (intended to limit the foreign tax credit to the amount of U.S. tax imposed on foreign source income, and imposed separately with respect to different types of income, referred to as "separate limitation categories" or "baskets").[37] In that case, if all other requirements for the credit were met, the taxpayer's foreign tax credit would be $30 (the amount of the country X tax), and its U.S. tax would be $5 ($35 of pre-credit U.S. tax less $30 of the foreign tax credit for the country X tax). This is a very simplified example—entire multi-volume series are written on the foreign tax credit rules.

For any given year, a U.S. taxpayer can choose to claim either credits or deductions for its foreign income taxes, but not both (with some exceptions).[38] Thus, if a U.S. taxpayer pays income taxes to Lithuania, Swaziland, and Thailand in the same tax year, the taxpayer may claim a credit for all of such foreign taxes (subject to many rules and restrictions) or a deduction for all of such taxes, but may not (generally) claim a credit for some of its foreign income taxes (*e.g.*, the Lithuanian taxes, or half of the taxes from each country) and a deduction for other foreign income taxes in the same

---

> (1980) (noting that the history of the credit "clearly demonstrates" that it was intended to eliminate "double taxation"); Am. Chicle Co. v. United States, 316 U.S. 450, 451, 62 S. Ct. 1144, 86 L. Ed. 1591, 96 Ct. Cl. 601 (1942) (1942); Burnet v. Chicago Portrait Co., 285 U.S. 1, 7, 52 S. Ct. 275, 76 L. Ed. 587, 1932 C.B. 286 (1932); Guardian Indus. Corp. v. United States, 477 F.3d 1368, 1374 (Fed. Cir. 2007); 56 Cong. Rec. App. 677-78 (1918) (statement of Rep. Kitchin); Joint Committee on Taxation, The Impact of International Tax Reform: Background and Selected Issues Relating to U.S. International Tax Rules and the Competitiveness of U.S. Businesses (JCX-22-06) (noting that "[a] resident has no incentive under a worldwide [tax] system either to move activities abroad or to keep them within the residence country. . . . Thus, investment-location decisions [by U.S. citizens, residents, and corporations] are governed by business considerations, instead of by tax law."). The purpose of the foreign tax credit is to permit substantive business decisions to be made largely independent of the tax consequences of the United States' worldwide system of taxation.

Salem I, 112 Fed. Cl. at 582 (alterations in original); *see also* BNY Mellon II, 801 F.3d 104, 114 (2d Cir. 2015) (discussing the purpose of the foreign tax credit and citing its legislative history); Norwest Corp. v. Comm'r, 69 F.3d 1404, 1407 (8th Cir. 1995).

[36] *See supra* note 35.

[37] *See* 26 U.S.C. § 904(a), (d) (2016).

[38] *See* 26 U.S.C. § 275(a)(4) (2016) (denying deduction for foreign income taxes if the taxpayer claims a credit for any foreign income taxes for the taxable year). *But see id.* § 901(k)–(m) (providing anti-abuse rules denying foreign tax credits for certain foreign taxes, but allowing a deduction for such taxes instead, even if the taxpayer claims credits for other foreign income taxes).

taxable year.

The foreign tax credit is a very valuable benefit to taxpayers, and a very costly one for the U.S. Treasury, because (like other credits) it causes a dollar-for-dollar reduction of the taxpayer's U.S. tax. In other words, as illustrated above, a $30 foreign tax credit reduces the taxpayer's U.S. tax by $30.[39]

C. The STARS Transactions: Fact Patterns

The recent STARS cases concerned claims of foreign tax credits that the U.S. government argued should be disallowed under the economic substance doctrine. Four such transactions were litigated in the federal courts. *BNY Mellon II*, *Salem II*, and *Santander III* held (on appeal) that the foreign tax credits lacked economic substance, but allowed interest deductions on related loans.[40] The *Wells Fargo* case reached the same outcomes (disallowing the foreign tax credits but allowing the interest deductions) at the trial level.[41] The Supreme Court has denied *certiorari* in *BNY Mellon II*, *Salem II*, and *Santander III*.[42]

The STARS transactions were very complex,[43] but in their essence all four cases presented the following pattern:[44] A U.S. bank ("U.S. bank") took

---

[39] Compare the effect of deductions, which reduce gross income (before income is multiplied by the tax rate to compute the final tax amount). For example, assume that the taxpayer in the numeric example above claimed a deduction rather than a credit for its foreign income taxes, and that it had no tax items other than the income and foreign taxes described above. The taxpayer's taxable income would be $70 ($100 less $30 deduction for country X taxes). Its U.S. tax would be $24.50 (35% tax rate x $70 taxable income). Thus, its U.S. tax is considerably higher with the deduction for foreign taxes than with the credit for foreign taxes: $24.50 compared to $5.00.

[40] The loan issue was not raised in *Santander III*. Santander III, 844 F.3d 15 (1st Cir. 2016).

[41] The *Wells Fargo* jury decided largely in the government's favor. The jury concluded that the trust and loan were two separate transactions (rather than one, as the taxpayer argued). The jury further found that neither transaction had a business purpose and that the loan had profit potential but the trust transaction did not. Subsequent to the jury's verdict, the parties in *Wells Fargo* submitted briefs on the question of whether a transaction that has profit but lacks business purpose (the loan, according to the jury's findings) has economic substance and on the issue of penalties. *See Wells Fargo II*, No. 09-CV-2764 at 2-3; *see also* Cara Salvatore, *Jury Sides with Feds In Wells Fargo $76M Tax Credit Suit*, LAW360 (Nov. 18, 2016), https://www.law360.com/articles/864145/jury-sides-with-feds-in-wells-fargo-76m-tax-credit-suit (last visited May 1, 2017); Wesley Elmore, *Jury Sides with Government in Wells Fargo STARS Case*, TAX NOTES TODAY (Nov. 18, 2016), http://www.taxnotes.com/tax-notes-today/litigation-and-appeals/jury-sides-government-wells-fargo-stars-case/2016/11/18/18673101 (last visited May 1, 2017). The court held that the loan would be respected, and interest deductions would be allowed. *Wells Fargo II*, No. 09-CV-2764 at 6.

[42] *See supra* note 6.

[43] *See, e.g.*, Santander I, 977 F. Supp. 2d 46, 48 (D. MA. 2013) ("[T]he transaction was surpassingly complex and unintuitive; the sort of thing that would have emerged if Rube Goldberg had been a tax accountant."). The Court of Claims opinion in *Salem I* has approximately 32 pages of factual description of the STARS transaction, before the court begins its analysis. *See Salem I*, 112 Fed. Cl. at 550-82.

[44] The following description in the text is a high-level summary of the basic facts that all of the STARS cases had in common – a skeleton overview of the fact pattern that was repeated, with variations, in all of the STARS cases. The details, especially the amounts involved, varied slightly from case to case, but the basic structure remained the same in all of the STARS cases. The steps are also simplified above. For example, the U.S. bank implemented some of these steps through newly formed, wholly owned (indirectly through the U.S. bank's related parties) U.S. entities (subsidiaries or partnerships). Throughout this article, references to the U.S. bank include its U.S. subsidiaries, except where the context requires otherwise. The

assets that it already owned, and that were located in the U.S., and placed those assets in a trust ("the trust"). The trust was a partnership for U.S. tax purposes. The assets were generally loans (or participation interests in loans) and securities. Each U.S. bank moved several billion dollars of assets into its trust. The trust was owned by the U.S. bank (and its related parties), but had a U.K. trustee. The U.K. trustee was a wholly owned subsidiary of the U.S. bank. Because of the U.K. trustee, the income from the trust's assets became subject to U.K. tax. The income from the trust's assets was already subject to U.S. tax. Thus, after the assets were moved to the trust and the U.K. trustee was appointed, the same income from the assets was subject to both U.S. and U.K. tax.

Barclays, a bank located in the U.K., acquired units in the trust for X amount,[45] and promised to re-sell the units back to the trust for the same X amount (plus an amount computed by reference to an interest rate) after Y time period. This acquisition (with the obligation to re-sell, and other agreements) was treated as a loan from Barclays to the trust, for U.S. tax purposes,[46] but Barclays was treated as owning an equity interest in the trust for U.K. tax purposes.

U.K. tax was imposed on the income from the trust's assets. Under U.K. law, the trustee (a U.K. subsidiary of the U.S. bank) had the legal liability for and paid such tax (from funds set aside by the trust).[47] Barclays claimed a credit for the trust's tax[48] against its own U.K. corporate income tax, for U.K. tax purposes. The U.S. bank claimed a U.S. foreign tax credit for the same U.K. taxes of the trust.

Periodically, the trust paid distributions with respect to the units held by the U.S. bank. It paid the remainder of its income (generally equal to total income less U.K. taxes, distributions paid to the U.S. bank, and management fees) as distributions on the units held by Barclays. However, instead of paying those amounts directly to Barclays, it paid the amounts to a blocked account that was held in Barclays' name, located at the U.S. bank, and to which Barclays had no access. Those distribution amounts were then automatically sent back to the trust, as a contribution for which Barclays

fact patterns also included zero coupon swaps, security arrangements, and multiple classes of interests (or trust units) issued to Barclays, all of which are omitted above for simplicity.

[45] The amounts varied from case to case.

[46] *See, e.g.*, *BNY Mellon I*, 140 T.C. at 23 (stating that "In sum, the forward sale agreements, the zero coupon swap and the security arrangements converted Barclays' initial subscriptions for the class C unit and class D unit [in the trust] into a secured loan from Barclays to BNY for $1.5 billion at LIBOR plus 20 basis points . . . ."); *Salem I*, 112 Fed. Cl. at 571 (the loan resulted from the subscription agreements (regarding the trust units), the forward sale agreements regarding those trust units, and the zero coupon swap).

[47] *See, e.g.*, BNY Mellon I, 140 T.C. 15, 27-28 (2013).

[48] For simplicity, the remainder of this article refers to the U.K. taxes imposed on the trust's income as the trust's taxes, even though the trustee technically had legal liability for the taxes under U.K. law.

received additional trust shares.[49] No matter how many additional trust shares Barclays acquired, it was obligated to sell all of its trust shares back to the trust for its original X purchase price plus the amount computed with reference to an interest rate. These steps, and the obligation to re-sell, generated a loss for Barclays for U.K. tax purposes, with respect to the additional shares.

Barclays periodically paid the U.S. bank an amount called the "Bx payment," which was computed (under the transaction documents) as Z% of the U.K. taxes owed by the trustee on the trust's income. Z% varied slightly from case to case, but was always around 50%.[50]

The interest rate on the loan was higher than LIBOR.[51] The parties offset the Bx payment (owed by Barclays to the U.S. bank) against the interest owed from the U.S. bank to Barclays on the loan, and Barclays paid the U.S. bank the net of those amounts. The parties claimed that, taking the Bx payment into account (*i.e.*, treating the Bx payment as an offset of the interest rate), the loan was made at a below-market rate.[52] This, of course, depends on viewing the Bx payment as relating to the loan, rather than to the trust.

The U.S. bank claimed foreign tax credits for the U.K. taxes owed by the trustee on the trust's income.[53] The U.S. bank also reported the Bx payment as income, and it treated the income from the trust's assets as foreign source (which improved its ability to use foreign tax credits).[54] It also claimed interest deductions for interest paid on the loan from Barclays. For U.K. tax purposes, Barclays claimed a credit against its U.K. corporate tax for the U.K.

---

[49] The *Salem I* court emphasized that the transaction involved circular cash flows. *Salem I*, 112 Fed. Cl. at 555.

[50] *Salem I* explained that under the taxpayer's position, "STARS thus had the counterintuitive result that the greater the amount of foreign taxes paid by the taxpayer, the greater the amount of profit realized from the Bx rebate payments." *Id.* at 586.

[51] LIBOR is the London Interbank Offered Rate, which is the rate at which banks loan money to each other. *See, e.g.*, Salem II, 786 F.3d 932, 937 n.1 (Fed. Cir. 2015) (defining LIBOR as the "Intercontinental Exchange London Interbank Offered Rate"); *BNY Mellon I*, 140 T.C. at 19 n.5 (defining LIBOR as the London Interbank Offering Rate); *BNY Mellon II* at 108 n.3 (defining LIBOR as London Interbank Offered Rate).

[52] The *Santander* lower court agreed with this characterization. *See Santander I*, 977 F. Supp. 2d 46, 48-49 (noting that Barclays' obtaining U.K. tax benefits allowed it to offer a lower "effective lending rate to a U.S. bank").

[53] The U.S. bank presumably used former section 902 (repealed in 2017) to claim foreign tax credits for the U.K. taxes paid by its U.K. subsidiary (the trustee) with respect to the trust's income (although the STARS opinions do not explain this detail). *See* former 26 U.S.C. § 902 (repealed 2017) (treating foreign taxes of certain foreign corporations as "deemed" paid by U.S. corporations who own at least 10% of the voting stock of such foreign corporations, under certain circumstances). It is possible that, instead, the U.S. bank elected to treat the U.K. trustee as a disregarded entity, or that it defaulted to disregarded entity status under the U.S. tax regulations. *See* Treas. Reg. § 301.7701-3. But that fact does not appear in the STARS opinions.

[54] Under section 904(a), foreign tax credits are limited to the lesser of foreign income tax paid (or accrued) or the result of the following formula, which is called the "limitation fraction" or the "foreign tax credit limitation fraction": U.S. tax x (foreign source taxable income/worldwide taxable income). 26 U.S.C. § 904(a) (2016). Therefore, treating the trust's assets' income as "foreign source" increased the limitation fraction, improving the U.S. banks' ability to use foreign tax credits for the U.K. taxes on the STARS transaction and for other foreign taxes.

taxes paid on the trust's income (the same taxes for which the U.S. bank claimed a U.S. foreign tax credit), a loss to reflect its mandatory recontributions to the trust, and a deduction for the Bx payment.

The following summary (from *Salem II*) reflects a simplified numeric example used by all three of the STARS appellate courts:[55]

> For every $100 of Trust income, Barclays (1) paid $30 in [U.K.] corporate income tax; (2) claimed a $22 tax credit [against its U.K. corporate income tax] for taxes already paid by the Trust; (3) claimed a [U.K.] trading loss deduction worth $23.40 for the cash it recontributed to the Trust; and (4) claimed a [U.K.] deduction for the Bx payments that was worth $3.30. Those payments, credits, and deductions gave Barclays a net total of $18.70 in U.K. tax benefits, out of which Barclays paid $11.00 to BB&T in the form of the Bx payment.[56]

For each such $100, the U.S. bank claimed a foreign tax credit of $22, received the Bx payment of approximately $11 (depending on the case), which it treated as income, and paid $22 of U.K. taxes on the trust's behalf (through the trust or the trustee). The U.S. bank's net effect (ignoring transaction costs) was thus a net loss of approximately $11 (equal to foreign taxes paid of $22, partially offset by the Bx payment of $11), plus a U.S. foreign tax credit of $22. The U.K. Treasury received $22 for the trust's taxes, and gave $18.70 of tax benefits to Barclays, for a net positive U.K. tax of $3.30 from the STARS transactions (from the trust and Barclays in the aggregate).

The U.S. bank would not have engaged in the STARS transaction if it could not have used the foreign tax credit, *e.g.*, if it already had more foreign tax credits than it could use before they expired, or if it had net operating losses (NOLs) and was therefore deducting rather than crediting its foreign taxes.[57] If the U.S. bank claimed deductions for its foreign income taxes, then for every $100 of income earned on the trust's assets, it would have owed $22 of U.K. tax, received a Bx payment of approximately $11, and claimed a U.S. tax deduction worth 35% of $22 (or $7.70) (assuming a 35% U.S. tax rate). In that case, subjecting the pre-existing $100 of income (from the U.S. bank's previously owned assets) to U.K. taxes would have resulted in a net loss even

---

[55] This streamlined example does not reflect the actual numbers of any case, but was used by the *Salem II* court, and then repeated in several other STARS opinions, in an effort to convey the basic economics and effects of the STARS transaction using a simplified fact pattern. *See* Salem II, 786 F.3d at 938; *see also* BNY Mellon II, 801 F.3d 104, 111 (2d Cir. 2015); *Santander III*, 844 F.3d 15, 20-21 (explaining that "The benefits for both parties can be illustrated by a hypothetical also employed by the Second and Federal Circuits.").

[56] *Salem II*, 786 F.3d at 945–46.

[57] *See* 26 U.S.C. § 164 (2016) (allowing a deduction for foreign income taxes).

after the U.S. tax deduction, as compared to the pre-STARS treatment of such $100.

In the big picture, from the U.S. taxpayer's perspective, the transaction worked somewhat like a Groupon ($22 of foreign tax credits for only $11 of cost), except that the business whose goods are being discounted did not consent. To change the numbers, it was as if the literal words of a federal statute inadvertently allowed Groupon to sell to the U.S. taxpayer—for a price of $53—a coupon worth $100 of restaurant food, services, or foreign tax credits, without the permission of the restaurant, service provider, or U.S. government.[58] This is not a perfect analogy, because the $53 does not go to the U.S. government but to the U.K. The analogy also does not take into account the U.K. Treasury's role in providing U.K. tax benefits to Barclays. But the foreign tax credit theoretically intends to provide a dollar for dollar credit for the foreign tax costs of the U.S. taxpayer.[59] Here, the U.S. taxpayer does not bear the entire cost. The essential benefit of the transaction for the U.S. taxpayer is that the U.S. bank shares the economic burden of the foreign tax with Barclays, but claims a credit for 100% of the foreign tax.

Neither the foreign tax credit generator regulations[60] nor section 7701(o) apply to the STARS transactions, which occurred in years before those provisions' effective dates. Instead, the government challenged the foreign tax credits in the STARS cases under the economic substance doctrine, claiming that the trust transaction that generated the foreign taxes lacked a reasonable expectation of profit (or other economic effect) and also had no business purpose, and that all tax consequences of the STARS transactions (foreign tax credits, interest deductions, etc.) should be denied. The government did not attempt to use other available weapons, such as the subsidy rule or the compulsory payment rule (discussed below), choosing instead to rely on the broad judicial doctrine of economic substance.[61]

All of the STARS courts examined both objective (especially profit) and subjective factors, although they described the economic substance test variously as conjunctive, as not needing a subjective purpose analysis, or as a flexible analysis that includes examination of both objective and subjective factors.[62]

---

[58] This example is based on the numbers in *Wells Fargo I*: Barclays periodically paid Wells Fargo a Bx payment of approximately 47% of the trust's U.K. tax, so that Wells Fargo bore a net cost of approximately 53% of the trust's U.K. tax. Wells Fargo claimed a U.S. foreign tax credit for 100% of the trust's U.K. taxes. Wells Fargo I, 143 F. Supp. 3d 827, 833 (D. MN. 2015).

[59] *See supra* note 35.

[60] *See* Treas. Reg. § 1.901-2(e)(5)(iv) (2016).

[61] The government did raise several other arguments based on similarly broad, facts and circumstances, non-mechanical tests, such as section 269 and the substance over form doctrine. *See, e.g., Wells Fargo I*, 143 F. Supp. 3d at 847-52. The courts rejected these arguments when raised (*see, e.g., id.*), and they were not raised in the appellate process. *See, e.g., Santander III*, 844 F.3d at 19 n.3.

[62] *See supra* notes 22-27 and accompanying text. *Santander I* found that the STARS transaction met the objective prong and that it was therefore unnecessary to consider business purpose, although the court

The STARS cases decided for the government on the disallowance of the U.S. banks' foreign tax credits, by reason of the economic substance doctrine, with the exception of the lower court in *Santander* (which held for the taxpayer, but was reversed). All of the STARS cases allowed the interest deductions on the loan, declining to disallow it as lacking economic substance. (The government did not raise the issue on appeal in *Santander III*.) *Salem II* and *Wells Fargo II* also imposed penalties, while *Santander III* remanded on the penalties issue.[63]

After the STARS transactions occurred, but before they were litigated, the Treasury and IRS issued regulations to address these and similar transactions. The regulations, colloquially referred to as the "foreign tax credit generator regulations," list six specific factors. If a transaction fails all six factors, the foreign tax credits from the transaction are disallowed on the grounds that they are noncompulsory.[64] The basic theory of the regulations is that if taxpayers engage in a real business transaction (such as holding assets or making a loan) using a structure that is much more complicated than actually necessary, and if the purpose of such complexity is to deliberately trigger additional foreign tax (which would otherwise not be imposed if the transaction were done more directly), and the cost of the foreign taxes is partly borne by an unrelated counterparty, then the foreign taxes are essentially voluntary, and not the incidental result of real business conduct.[65]

This concept is implemented through the following six factors: the transaction uses a special purpose vehicle whose income and assets are substantially all passive and whose income is subject to foreign tax, a U.S. person would be eligible for a credit for such foreign taxes (absent these regulations), the potential foreign tax credits are higher than if the transaction were done directly (*e.g.*, without the special purpose vehicle), there is an unrelated counterparty, the unrelated counterparty is eligible for particular

---

did examine the subjective prong (regardless) in the interests of thoroughness. *Santander III* (decided by the First Circuit) similarly stated a disinclination to examine business purpose, but nonetheless mentioned the lack of such a purpose. First the court states, "This court has been particularly wary of inquiring into the subjective motivations of taxpayers: '[U]nless Congress makes it abundantly clear, we do not think tax consequences should be dependent upon the discovery of a purpose, or a state of mind, whether it be elaborate or simple.'" Santander III, 844 F.3d 15, 22 (1st Cir. 2016) (alteration in original). But then the court gives some brief conclusions about the *Santander* taxpayer's lack of business purpose: "Using similar reasoning, we find that the Trust transaction is 'shaped solely by tax-avoidance features,' . . . that 'lack a bona fide business purpose' . . . ." *Id.* at 23. The court also states, "We have used Sovereign's and Barclays's communications to each other about the transaction and, in particular, their emphasis on the connection of the Bx payment to Sovereign's U.K. taxes and the Trust transaction's 'tax risk,' to conclude that the Trust transaction had no objective purpose outside its tax effect." *Id.* at 22 n.10.

[63] *See Salem II*, 786 F.3d 932, 960 (Fed. Cir. 2015) (finding "that the trial court did not err in imposing accuracy-related penalties on BB&T. The amount of the penalties, however, requires reassessment, as we have found that BB&T is entitled to claim interest deductions for the interest it paid on the STARS Loan"); Wells Fargo II, No. 09-CV-2764 at 19; Santander III, 844 F.3d 15, 26 (1st Cir. 2016). An in depth discussion of the penalty provisions is beyond the scope of this article.

[64] *See* Treas. Reg. § 1.901-2(e)(5)(iv) (2016).

[65] *See* T.D. 9416, 2008-2 C.B. 1142, 2008-46 I.R.B. 1142 (2008) (describing the temporary regulations that preceded the current final regulations).

types of tax benefits in a foreign country, and certain kinds of hybridity (different treatment by the U.S. and foreign tax systems) are present.[66] These factors contain much more detail than briefly described above. A transaction must fail all of these detailed factors in order to fail the regulatory test. Therefore, because escaping any factor is sufficient to evade the regulations, one can expect that many transactions in the future may raise concerns similar to the STARS fact patterns, while not literally falling within the foreign tax credit generator regulations.

D. *Why Are These Transactions Offensive, When Others Are Tolerated?*

1. In General

Given all of the arguable inaccuracies in the foreign tax credit rules,[67] and given the taxpayer windfalls that are allowed in other circumstances, the STARS cases raise an obvious question about why these particular transactions are seen as offensive, when others are tolerated. The STARS opinions do not clearly articulate an answer to this question. They discuss why the STARS cases violate the purpose of the foreign tax credit (because the taxpayer did not bear the full economic cost of the foreign taxes, and the trust transaction was economically pointless, consisting of the U.S. bank retaining control of its assets, using a U.K. trustee to incur U.K. tax, and engaging in circular cash flows). But the government does not explain why these transactions should be addressed when other (also arguably problematic) foreign tax credits (for which the U.S. person does not bear the full cost, or for which there appears to be no income or no useful business activity) go without challenge. They focus on the pieces of the economic substance doctrine, without parsing why these particular transactions were chosen as a target for an economic substance analysis. The economic substance doctrine is not the reason why the STARS transactions are troubling, just the means for disallowing the benefits.

Yet something about the STARS transactions clearly troubles the courts and the government more than other transactions that arguably also depart from the foreign tax credit's purpose. What distinguishes these transactions appears to be the *combination* of the taxpayer's lack of economic burden for the foreign taxes (the Groupon effect of getting 2X of foreign tax credits for X of net cost to the taxpayer), a lack of any useful business activity, and the fact that the Groupon effect actually *causes* the taxpayer's transaction (rather than being a by-product of other activity), even though any one of those factors alone would be tolerated. Each of the relevant factors identified

[66] *See* 26 U.S.C. § 1.901-2(e)(5)(iv)(B)(1)–(6).

[67] *See, e.g.*, Nissho Iwai Am. Corp. v. Comm'r, 89 T.C. 765, 778–79 (1987) (*Nissho Iwai*); Guardian Indus. Corp. v. United States, 477 F.3d 1368, 1369 (Fed. Cir. 2007).

above is discussed further below.

The taxpayers in the STARS cases did not bear the full cost of the U.K. taxes for which they claimed foreign tax credits, which is troubling in light of the policy of the foreign tax credit. In the STARS fact patterns, each U.S. bank received a Bx payment from Barclays of approximately 50% of the trust's U.K. taxes. The Bx payment was computed, under contract, as a percentage of the trust's U.K. taxes. It functioned as a reimbursement by Barclays of part of the trust's U.K. tax, so that the U.S. bank bore a net cost of approximately half the U.K. tax (which was also approximately half of the foreign tax credit). In the *Wells Fargo* case, for example, Barclays reimbursed Wells Fargo $0.47 for every dollar of U.K. tax. Given that the policy of the foreign tax credit is to reduce the burden of duplicative U.S. and foreign tax on the same income, one could point out that Wells Fargo only bore the burden of $0.53 of each dollar of U.K. tax. Arguably, then, Wells Fargo did not need a foreign tax credit for a full 100% of the U.K. tax, but only for the 53% of the tax that it bore.

Although this has some logical appeal,[68] it is not how the technical rules of the foreign tax credit work. Instead, "legal liability under foreign law" for a foreign tax determines which person is eligible for a U.S. foreign tax credit for such tax.[69] In fact, lack of economic burden for foreign taxes claimed as a credit is clearly tolerated in other transactions. For example, in *Nissho Iwai American Corp. v. Commissioner*, the tax court referred to a lender's foreign tax credit as a "windfall" because its foreign taxes were borne by the borrower in a net loan arrangement.[70] But that lack of economic burden did not cause the *Nissho Iwai* court to disallow the foreign tax credits.[71] This raises the question of how this characteristic of the STARS cases (reimbursement by another party, or the lack of full economic burden on the person with "legal liability") differs from net loan cases (like *Nissho Iwai*) and the many other (unchallenged) situations where one party bears the economic burden of the foreign tax but another has legal liability (and the

---

[68] Other courts have found lack of economic burden for foreign taxes troubling, from a policy perspective, in foreign tax credit cases, even though it is not determinative of whether a foreign tax credit is allowed. *See, e.g.*, Amoco Corp. v. Comm'r, 138 F.3d 1139, 1149 (7th Cir. 1998) (*Amoco*) (assuming the economic burden must have been shared by means of other contract terms, and implying that lack of economic burden would be troubling as a policy matter); Nissho Iwai, 89 T.C. 765, 778 (1987) (allowing a foreign tax credit, although the burden fell on the borrower rather than the U.S. taxpayer, and apparently agreeing that such credit, while allowable, was not ideal from a policy perspective). These aren't economic substance cases, but they did raise, directly or indirectly, issues concerning when a foreign tax credit is appropriate from a policy perspective.

[69] Treas. Reg. § 1.901-2(f)(1).

[70] *Nissho Iwai*, 89 T.C. at 776. In exchange for the loan from Nissho Iwai (a U.S. bank), a Brazilian borrower contracted to pay interest and also (from its own funds, not by withholding such amounts from the interest owed to the bank) any Brazilian withholding tax owed on such interest. Thus, the lender received the same amount of interest from the borrower regardless of whether the Brazilian withholding tax increased or decreased.

[71] The court did disallow some of the taxpayer's foreign tax credits under a different theory, using the subsidy rule. *See id.* at 778.

potential for a foreign tax credit). Thus, lack of economic burden in the STARS cases is an annoyance to the judges and to policy considerations,[72] and it helps explain why the transactions were attractive to the taxpayer, *but it is not part of the actual legal test* for whether a taxpayer is eligible for a foreign tax credit. Instead, the foreign tax credit regulations tolerate such situations.

Similarly, lack of economic burden for the foreign taxes does not necessarily affect the analysis under the two prongs of the economic substance test, except, perhaps, to the extent that economic burden affects the calculation of economic profit or increases the ratio of tax purpose to non-tax purpose. Less economic burden either should not affect the computation of "profit" for economic substance purposes (as argued below) or should increase such profit (by decreasing costs). Either way, lesser economic burden for foreign taxes does not hurt the taxpayer in the mechanics of the economic substance analysis, even if it is part of the reason why the transaction is offensive. On the other hand, reduced economic burden for foreign taxes could theoretically increase tax-related purpose, as part of the subjective analysis. But there is not currently a clear requirement that the relative size of tax purpose be taken into account, as part of determining whether business (non-tax) purpose is sufficiently large.[73] Overall, lack of economic burden is not a clear negative for the taxpayer under the economic substance test.

One distinction between the cases that are tolerated (discussed above), and the STARS cases, is that the latter featured a lack of real business impact or activity. The STARS taxpayers were not engaged in real business conduct, while the taxpayer in *Nissho Iwai* (and other Brazilian net loan lenders) were engaged in business transactions that had potential for economic profit (and risk of economic loss, *e.g.*, risk of the borrowers defaulting).[74] *Nissho Iwai* was somewhat troublesome as well—the court called the foreign tax credit a "windfall" to the taxpayer.[75] But it was a real business transaction—lending—which served non-tax purposes and which the lender presumably might have done even without the U.S. foreign tax credit. In the STARS cases, in contrast, there was no useful activity (just placing existing assets in a wholly owned trust, appointing a related U.K. trustee, and engaging in circular cash flows). There was also little or no risk (because of the contractual terms), which reduced any economic impact of the

---

[72] For example, the *Wells Fargo I* court said that the foreign tax credit is intended for "actual out-of-pocket [foreign] tax payments." Wells Fargo I, 143 F. Supp. 3d 827, 836 (D. MN. 2015). "Out of pocket" implies that the taxpayer is supposed to have the economic burden of the foreign taxes.

[73] Lesser economic burden for the foreign taxes might, however, affect a bigger picture analysis of whether a transaction is within the purpose of the foreign tax credit.

[74] *See Nissho Iwai*, 89 T.C. at 775–76; Cont'l Ill. Corp. v. Comm'r, 998 F.2d 513 (7th Cir. 1993).

[75] *Nissho Iwai*, 89 T.C. at 776.

transaction.[76]

If one theorizes that the purpose of the foreign tax credit is to remove tax impediments to real business activity, and that all of the foreign tax credit rules' inaccuracies and compromises are tolerated with respect to real business transactions (but are not intended to provide the only cause for or substance of a transaction), then transactions like STARS are outside of the policy of the foreign tax credit, and go beyond acceptable inaccuracies therein. Foreign tax credits claimed in the STARS cases were arguably a waste of the U.S. Treasury's funds, because no real business activity was enabled.

But none of this prevents a foreign tax credit, under the credit's technical rules. Instead, lack of business activity is acceptable under such rules if there is profit, such as a fee for an accommodation party's pro forma participation. For example, if a taxpayer were paid to sign its name as a pro forma shareholder or director of a foreign corporation, U.S. tax law generally would treat the payment as income,[77] and would treat foreign taxes on that payment as being eligible for a foreign tax credit (if all other requirements were met). The fact that no useful business activity occurred would generally not prevent this treatment, absent other factors.

One element that distinguishes the STARS cases, partly, is that the payment that the U.S. banks received for participating (the Bx payment) was less than their expenses, *i.e.*, they had a net loss from their participation in the trust.[78] But even a lack of profit does not prevent foreign tax credits in other circumstances. Foreign tax credits can be allowed with respect to foreign taxes imposed on amounts that the U.S. does not perceive as income (and on events that the U.S. does not perceive as profitable transactions).[79] (Such

[76] The *Santander III* court, for example, took into account the parties' lack of non-tax risk (partly due to contractual indemnities), the point that "Sovereign's U.K. tax was artificially generated through a series of circular cash flows," (so that no business activity actually occurred), and the facts that the trust's assets never actually changed control (remaining under the U.S. bank's control) and that such assets' income did not increase by reason of the STARS transaction. Santander III, 844 F.3d 15, 26 (1st Cir. 2016). There was thus no business impact.

[77] *See* 26 U.S.C. § 61 (2016) (defining income to mean "all income from whatever source derived").

[78] Also, the amount of the foreign tax credit rose and fell in *Nissho Iwai* and *Amoco* in conjunction with profit (for example, more foreign tax credit as profit increased, less foreign tax credit as profit decreased). In the STARS cases, in contrast, the foreign tax credit rose as the taxpayer's net loss increased (if foreign taxes are treated as a cost). This may be taken into account under the subjective business purpose prong of the economic substance doctrine as part of considering relative amounts of tax and non-tax purpose.

[79] *Cf.* 26 U.S.C. § 904(d)(2)(H) (2016); Treas. Reg. § 1.904–6(a)(1)(iv) (2016) (providing rules on how to "basket" foreign taxes on amounts that the U.S. does not perceive as income). Foreign taxes can be imposed even when U.S. tax law does not see a profit. This can occur where foreign tax law computes net income differently than U.S. tax law; for example, by allowing fewer deductions, respecting circular cash flows, or taxing a payment between a "disregarded entity" and its parent. Foreign taxes on such amounts can be claimed as foreign tax credits, if all of the applicable requirements (including the foreign tax credit limitation) are met. *Cf.* 26 U.S.C. § 901(m) (2016) (addressing specific fact patterns in which foreign law sees net income and U.S. tax law does not, and denying foreign tax credits in some of such circumstances,

credits are beneficial because they can potentially be used to reduce U.S. tax on other foreign source income, if the applicable requirements are met.) Even the economic substance test does not always require profit: it examines the objective possibility of profit, but also considers whether there was instead a change in economic circumstances (in the absence of profit).[80] Also, before the effective date of section 7701(o), circuits applying the disjunctive version of the economic substance test could theoretically hold in the taxpayer's favor based on the subjective business purpose prong, even if the transaction failed the profit analysis.

Another factor that distinguishes the STARS cases is that the discounted-cost foreign tax credit is the cause of the transaction for the U.S. taxpayer—rather than just being the side effect of a real business activity.[81] In *Nissho Iwai*, in contrast, the taxpayers arguably received a windfall of greater than their cost for the foreign taxes, but the foreign tax credit appeared to be a by-product of real business activity (lending), rather than the sole cause of the lending transaction. In the STARS transactions, it was relatively clear that the only reason for the U.S. banks' participation was the opportunity to get discounted-cost foreign tax credits. (They could have gotten lower cost financing, compared to the loan, elsewhere, and there was no (or minimal) gross income other than the Bx payment, which was less than foreign taxes and transaction costs.) This causation is contrary to the purpose of the foreign tax credit, which is to decrease the impact of U.S. tax on taxpayer's business decisions, not to *cause* meaningless activity.[82]

One could consider the distinction made in *Yosha. v. Commissioner* between abusive and non-abusive transactions: the *Yosha* court said that there were some transactions that some taxpayers would engage in even without the tax benefit, even though other taxpayers might be motivated mostly or entirely by the tax benefit.[83] One could consider mortgages as belonging to this category. The court implicitly contrasted other transactions that no rational person would enter into without the tax benefit. If we examine the STARS transactions through this lens, no rational person would engage in the STARS transaction without the foreign tax credits, because costs are approximately twice the gross income from the trust arrangement. The U.S. banks might agree to engage in the STARS transaction for larger Bx fees and fewer foreign tax credits (*e.g.*, a Bx fee of greater than the U.K. tax and

which reinforces the fact that foreign tax credits are generally allowed for such foreign income taxes absent a specific rule to the contrary).

[80] *See, e.g.*, BNY Mellon II, 801 F.3d 104, 119 (2d Cir. 2015); Salem II, 786 F.3d 932, 942–43 (Fed. Cir. 2015); *cf.* 26 U.S.C. § 7701(o).

[81] *See, e.g.*, Santander III, 844 F.3d 15, 25 (1st Cir. 2016).

[82] *See supra* note 35.

[83] *See* Yosha v. Comm'r, 861 F.2d 494, 499 (7th Cir. 1988) (stating that "A transaction has economic substance when it is the kind of transaction that some people enter into without a tax motive, even though the people fighting to defend the tax advantages of the transaction might not or would not have undertaken it but for the prospect of such advantages--may indeed have had no other interest in the transaction.").

transaction costs, leading to a net pre-*U.S.*-tax profit), but Barclays would not, because it needs to pay the U.S. bank less than Barclay's own U.K. tax benefits (which are Barclay's profit from the trust transaction). Such a transaction (with higher Bx fees and lower foreign tax credits) thus could not occur, practically speaking.

The *Yosha* distinction can be seen as a difference between "the tail wagging the dog" (tax benefits are driving the form of a real business transaction), which is often acceptable, and pinning a paper tail to the wall with no dog, which is not deserving of tax benefits. Much of what bothers the government is the complete lack of any logical business reason to subject the assets to U.K. tax — the absence of any real economic effect, apart from U.K. tax costs. The U.S. tax benefits claimed in connection with the STARS cases were not incidental to a real transaction or business purpose—they were the only reason for the transaction, from the U.S. bank's point of view. The STARS transactions thus differed from cases like *Esmark v. Commissioner*[84] and *Frank Lyon v. United States*,[85] both of which involved real activity that was done in a tax-advantaged way. The STARS transactions, in contrast, contained no real business activity at all (with the arguable exception of the loans). Yet even tax motivation (or causation) could be tolerated if the transaction had sufficient profit or economic effects. Such effects are lacking in the STARS cases.

In summary, the STARS transactions combine three factors (lack of full economic burden for the foreign taxes, lack of useful business activity, and causal impact of the tax benefit), in combination with the classic economic substance factor of insufficient profit potential, that are each troubling from a policy perspective. But none of these factors alone would prevent a foreign tax credit, absent other considerations. It appears to be the combination of these three factors (together with lack of profit potential) that makes the STARS transactions less acceptable than other questionable (from a policy view) claims of foreign tax credits. Yet, of these factors, only causation and lack of profit potential are reflected in the actual tests for respecting the credit (because causation is incorporated in the business purpose analysis of the economic substance test, and profit affects the analysis under both prongs). There is thus a gap between what bothers the government, on the one hand, and the tests used to deny the foreign tax credit, on the other. It might be useful for the government to articulate this combination of factors (at least the first two, which may be easier to test) in future guidance.[86]

---

[84] Esmark, Inc. v. Comm'r, 90 T.C. 171, 195-96 (1988), *aff'd without pub'd op.*, 886 F.2d 1318 (7th Cir. 1989).

[85] Frank Lyon Co. v. United States, 435 U.S. 561, 583–84 (1978).

[86] *See infra* Part IV for a discussion of possible alternative approaches.

2. Cross-Border Arbitrage: Moral Outrage

This general fact pattern, where a U.S. taxpayer and an unrelated foreign taxpayer engage in a transaction aimed at deriving tax benefits for both of them, from their respective jurisdictions, sometimes including duplicative credits or deductions in two countries for the same amounts, is commonly referred to as "cross-border arbitrage."[87] It was not a focus of the classic, earlier economic substance cases, which largely addressed domestic transactions. Cross-border arbitrage has been seen as a potentially abusive fact pattern in recent years (*e.g.*, in former Notice 98-5 and in the foreign tax credit generator regulations).[88] It also gives rise to questions of whether the U.S. should attempt to stop taxpayers from taking advantage of foreign countries' tax systems—*i.e.*, does the U.S. feel responsible, for reasons of moral outrage or otherwise, for preventing the abuse of foreign law?

In the STARS cases, Barclays is arguably taking advantage of the U.K. tax system by claiming U.K. tax benefits that are not connected to real business activity (but result from the circular STARS cash flows and Barclays' interest in the trust, whose assets are still controlled by the U.S. bank). The U.K. Treasury actually receives a net tax increase from the STARS transaction, though: Barclays receives net tax benefits from the U.K., but the trust's taxes slightly exceed those benefits. In any event, cross-border arbitrage seems not to be a main reason for the courts' discomfort with the STARS cases,[89] nor is it taken into account in the two prongs of the classic U.S. economic substance analysis. Instead, in the STARS cases, the counterparty's foreign benefits seem relevant mostly for the way that they explain Barclays' motivation for engaging in the transaction.

In contrast, the foreign tax credit generator regulations list the counterparty's foreign tax benefit as a factor,[90] and former Notice 98-5 also took such benefits into account in determining which foreign tax credits should be subject to heightened scrutiny. The tax benefit granted by the foreign country is a good diagnostic tool in those contexts—not necessarily for its own sake (the impact on the foreign country's tax system) but because it implies that the U.S. person is not bearing the full economic cost of the foreign tax. In other words, the counterparty's foreign benefits make the counterparty willing to share the economic burden of the U.S. person's

---

[87] *See, e.g.*, Diane M. Ring, *One Nation Among Many: Policy Implications of Cross-Border Tax Arbitrage*, 44 B.C. L. REV. 79, 80–81 (2002).

[88] *See* Treas. Reg. § 1.901-2(e)(5)(iv)(B)(4) (2016) (taking into account whether a counterparty or its related person can claim a tax benefit in a foreign country while a U.S. taxpayer claims a U.S. foreign tax credit).

[89] *But see* Santander Holdings USA, Inc. v. U.S., 144 F. Supp. 3d 239, 248 (D. MA. 2015) (commenting, after its analysis, that "It is almost as if the government thinks that, under a sort of aiding and abetting theory, Sovereign should be punished by taking away its credit for helping Barclays manipulate its benefits under the U.K. tax laws.").

[90] *See* Treas. Reg. § 1.901-2(e)(5)(iv)(B)(4).

foreign tax. In that case, there is not really a full double tax of the U.S. person, and therefore there is (in theory) no need for a foreign tax credit for 100% of the foreign taxes. Also, the counterparty's foreign benefits can cause one to suspect the transaction is not really "business" but instead motivated by tax benefits (even though the U.S. analysis focuses on the U.S. party).

In summary, cross-border arbitrage is not generally the element that appears most disturbing to the courts or to the IRS, although it is present in the STARS cases.[91] The STARS transactions were not viable from U.S. taxpayer's standpoint (without the foreign tax credit), regardless of what happened on the counterparty's side.

III. The Economic Substance Doctrine's Application to STARS (and Implications for Other Fact Patterns)

A. *Does the Economic Substance Doctrine Apply to Foreign Tax Credits?*

Preliminarily, the STARS cases raise the issue of whether the economic substance doctrine should be barred from applying to foreign tax credits at all. The doctrine does not apply where it has been preempted by Congress,[92] *e.g.*, by clear Congressional intent to allow tax benefits for non-economic transactions.

The foreign tax credit system is so complicated, contains so many careful, detailed balances between competing policies, and tolerates so many admittedly uneconomic results (*e.g.*, the ability to cross credit,[93] and the legal liability rule[94]) that one could legitimately ask whether Congress has preempted the field and precluded the application of the economic substance doctrine to foreign tax credits. Taxpayers could argue that the foreign tax credit was specifically designed to sometimes reward behavior that would otherwise be unprofitable (even if more-generous-than-accuracy benefits were not the primary purpose of the credit).

The government could respond that the compromises in the foreign tax credit system are a careful balance set by Congress and the executive branch (in the form of the IRS), rather than an acceptance of any and all

---

[91] Note that cross-border arbitrage is one of the differences between the STARS transactions and the stock sale and re-sale transactions in *Compaq* and *IES*. The latter two cases did not involve cross-border arbitrage (as defined above)—there was no counterparty claiming tax benefits under foreign law for the same items, or with respect to the same transactions, as the U.S. taxpayers. Instead, the U.S. taxpayers in *Compaq* and *IES* effectively paid the counterparties a fee for the counterparties' participation. *See* Compaq, 277 F.3d 778, 780 (5th Cir. 2001); IES, 253 F.3d 350, 352 (8th Cir. 2001).

[92] *See, e.g.*, Horn v. Comm'r, 968 F.2d 1229, 1236 (D.C. Cir. 1992); *contra* Gardner v. Comm'r, 954 F.2d 836, 838-39 (2d Cir. 1992) (analyzing the same statute and concluding that Congress had waived the subjective motive inquiry for the types of transactions at issue, but not the remainder of the economic substance test), *cert. denied sub nom.* 504 U.S. 910 (1992); Lerman v. Commissioner, 939 F.2d 44, 53-55 (3d Cir. 1991) (same), *cert. denied* 112 S. Ct. 590 (1991).

[93] *See generally* 26 U.S.C. § 904 (2016).

[94] *See* Treas. Reg. § 1.901-2(f)(1).

inaccuracies—*i.e.*, that Congress meant to accept some imprecisions but not others, and that the economic substance doctrine can therefore be applied to foreign tax credits. It could further contend that where the legislative and regulatory rules of the foreign tax credit compromise on accuracy for the sake of administrability and the competitiveness of U.S. businesses, they do so only for real business transactions,[95] in pursuit of the overall policy of preventing duplicative U.S. and foreign tax from unduly influencing taxpayers' choices between conducting business activities in the U.S. or activities abroad. Such compromises and occasional windfalls, the government could argue, were never intended to benefit non-business activity, or to cause transactions that have no content or motive aside from obtaining the credit. Under this reasoning, the STARS transactions are a step too far: they ask the U.S. Treasury to fund a tax benefit where there is no real business activity, and where the U.S. taxpayer's only motivation for and benefit from the transaction was obtaining a foreign tax credit without bearing the economic burden of the foreign tax.

Some of the rules that implement compromises and cause inaccuracies in the foreign tax credit area are put in place by the IRS, rather than by Congress. In particular, the "legal liability rule,"[96] which generally makes economic burden for the foreign taxes irrelevant for eligibility for the foreign tax credit, is contained in the regulations rather than the Internal Revenue Code. There appears to be no concept in the economic substance case law about the executive branch preempting the economic substance doctrine—only Congress seems to have that prerogative, because the economic substance test ultimately seeks to discern and implement Congressional (not executive) intent. However, taxpayers could argue that if the IRS has issued regulations that allow foreign tax credits in situations that arguably depart from the foreign tax credit's original policy, and if Congress has not (over time) acted to counteract such regulatory rules, then Congress has implicitly approved the regulations and thereby signaled that such rules are consistent with statutory intent.

However, as an additional factor, section 7701(o) can be read as implying that the economic substance doctrine applies to foreign tax credits: although it declines to describe when the economic substance doctrine is "relevant," it does specifically grant regulatory authority for the Treasury to determine when foreign taxes should be treated as a cost.[97] Foreign taxes are especially pertinent in foreign tax credit cases, where they cause the

[95] The court in *Santander III* stressed that the foreign tax credit was only intended to apply to real business transactions, although the court's points on this issue were not part of a discussion of whether the economic substance doctrine was relevant or not. *See* Santander III, 844 F.3d 15, 26 (1st Cir. 2016) ("Equally fundamental to the purpose of granting foreign tax credits is the related principle that those credits are extended only to legitimate business transactions." (citation omitted)).

[96] *See* Treas. Reg. §1.901-2(f)(1) (2016).

[97] *See* 26 U.S.C. § 7701(o) (2016).

challenged U.S. tax benefit. Treatment of foreign taxes as a cost had already been litigated in *Compaq* and *IES* (two foreign tax credit cases) before section 7701(o) was enacted. Therefore, it seems that Congress assumed that the economic substance doctrine applies to foreign tax credits, although it did not make any direct statement to that effect.

The STARS courts that addressed this question uniformly agreed that the economic substance doctrine applies to foreign tax credits.[98] Other than *BNY Mellon II*, none of such cases discussed the issue at length or in detail. *Santander III* relegates the issue to a footnote, but states that the economic substance test is necessary to keep up with taxpayers' "endless ingenuity," even though the Treasury regulations already provide detailed rules for foreign tax credits.[99] The Fifth Circuit in *Compaq* found it unnecessary to reach the question, because it decided that the transactions at issue met the economic substance test in any event (regardless of whether or not the test had been preempted by Congressional intent).[100] The Eighth Circuit in *IES* does not discuss the question of whether the economic substance doctrine might not be applicable.

For the reasons discussed above, the answer as to whether the economic substance doctrine applies to foreign tax credits was not a foregone conclusion, and the issue of the doctrine's applicability might be raised again in other circuits, in future foreign tax credit cases.

B. *What is the Arrangement Being Tested?*

As discussed above, one of the first steps in applying the economic substance doctrine to a fact pattern is delineating the transaction or

---

[98] *See, e.g.*, Salem I, 112 Fed. Cl. 543, 584 (2013) ("The application of the economic substance doctrine to foreign tax credits is fully consonant with the purpose behind such credits: to establish neutrality through the elimination of double taxation that would arise in the absence of foreign tax credits. Thus, the requirements of the economic substance doctrine – namely, that a transaction be pre-tax profitable and have a non-tax business purpose – are fully compatible with the foreign tax credit regime. . . . Accordingly, there is no foreign tax credit exception to the economic substance doctrine."); Santander III, 844 F.3d 15, 21 n.7 (1st Cir. 2016). The *BNY Mellon II* opinion also concluded that the economic substance doctrine applies to foreign tax credits. BNY Mellon II, 801 F.3d 104, 109–10 (2d Cir. 2015), *cert. denied*, Am. Int'l Grp., Inc. v. United States, 136 S. Ct. 1375 (2016). (The Second Circuit wrote one combined opinion for *AIG* and *BNY Mellon II*, but it discussed the two taxpayers' fact patterns separately within that opinion. AIG argued that the economic substance doctrine does not apply to foreign tax credits, but the Bank of New York Mellon did not raise this argument on appeal.) The *Wells Fargo* court opinions apply the economic substance doctrine without addressing an argument that such doctrine does not pertain to foreign tax credits. *See* Wells Fargo I, 143 F. Supp. 3d 827 (D. MN. 2015); Wells Fargo II, No. 09-CV-2764, 2017 U.S. Dist. LEXIS 80401, 2017-1 U.S. Tax Cas. (CCH) P50,235 (D. MN. May 24, 2017). In non-STARS cases, the Tax Court also confirmed the application of the economic substance doctrine to foreign tax credits in *Compaq*, while *Pritired* applied the economic substance doctrine to foreign tax credits without discussing whether the doctrine might be preempted. *See* Compaq Computer Corp. v. Comm'r, 113 T.C. 214, 225 (1999), *rev'd on other grounds*, 277 F.3d 778 (5th Cir. 2001); Pritired I, LLC v. United States, 816 F. Supp. 2d 693, 735-41 (S.D. Iowa 2011).

[99] *Santander III*, 844 F.3d at 21 n.7 (citation omitted).

[100] *See* Compaq, 277 F.3d 778, 788 (5th Cir. 2001).

transactions to be tested (an arrangement).[101] In the case of the STARS transactions, this required deciding whether the trust and loan are tested together as one arrangement, or are tested separately from each other. The courts also needed to decide whether holding the assets was a different arrangement than the trust transaction—if not, the income from holding the assets could be taken into account in determining profit from the STARS trust transaction, for purposes of the economic substance analysis.

Generally, economic substance cases isolate the transaction or transactions that were necessary to generate the challenged tax benefit, and treat those elements as one arrangement to be tested.[102] The pre-existing ownership of the assets is perhaps harder to analyze under this standard (compared to the loan): the income from the assets caused the U.K. tax, but not in previous years (before the assets were held in a trust with a U.K. trustee). The placement of the assets into a trust, and the naming of a U.K. trustee for the trust, were the proximate steps that caused the assets' income to become subject to U.K. tax. For that reason, the STARS cases generally treated the trust's creation, trust-related transactions with Barclays, and additional steps around the trust as the actions that resulted in the imposition of the U.K. tax (and caused the challenged foreign tax credit), and therefore as one arrangement to be tested (as the suspect, challenged steps, in essence). The assets' generation of income was treated as a separate transaction.[103]

This approach of separating the trust-related transactions from the assets' generation of income might have been more difficult if the assets were newly acquired in connection with the trust arrangement. Long-held assets and the new trust arrangement were presumably easier to separate from each other into different arrangements than items that co-occurred. The government might worry that, in the next case, the taxpayer will acquire assets and enter into a tax planning transaction simultaneously. However, the high dollar value of the assets in the STARS cases (billions of dollars of assets, in each case) makes it less likely that acquisitions of such high dollar amounts will occur often (and it is harder to generate large foreign tax credit claims with smaller amounts of assets).

The STARS courts also generally applied the economic substance doctrine separately to the trust transaction and the loan, on the theory that the foreign tax credits were generated solely by the former and that the loan did not affect the foreign tax credit claim.[104] The courts thus generally rejected

---

[101] *See, e.g.*, Notice 98-5 (withdrawn) (using this terminology).

[102] *See, e.g.*, Rice's Toyota World, Inc. v. Comm'r, 752 F.2d 89, 96 (4th Cir. 1985); ACM P'ship v. Comm'r, 157 F.3d 231, 262-63 (3d Cir. 1998).

[103] The *Santander III* court points out that the taxpayer in that case did not include the income from the trust assets when the taxpayer calculated the results of the trust transaction. *Santander III*, 844 F.3d at 27.

[104] *See, e.g.*, *Salem I*, 112 Fed. Cl. at 585 ("The Court agrees with the Government that the links between the Trust and Loan components of STARS are artificial, and further, that the disputed foreign tax credits are attributable solely to the Trust.").

taxpayers' arguments that the trust structure and loan were integrally related and were each necessary for the other. In support of its approach, one court noted that STARS was initially marketed to U.S. taxpayers without the loan component, implying that the loan was not necessary for the trust's main purposes.[105]

Several of the courts, despite holding that the loan and trust structures were better analyzed separately, nonetheless analyzed them using both alternate approaches: both separately and together. Almost all of the STARS courts found that the loan, analyzed separately from the trust, had economic substance and should be respected (so that interest deductions were allowable), even though the trust transaction (and foreign tax credits) was not respected.[106] (When the trust and loan were analyzed together, as an alternate approach, the combination was found to fail the economic substance test, except in the lower court in *Santander*.)[107] Thus, although the loan did not help the taxpayers prove that the foreign tax credits should be allowed (even when the trust and loan were analyzed together as one arrangement), analyzing the loan and trust separately actually benefited taxpayers by permitting the interest deductions from the loans to be respected.

---

105 *Salem I*, 112 Fed. Cl. at 558.

106 Both of the appellate courts that analyzed the loan reached this conclusion. The Tax Court originally found that the loan lacked economic substance, even when viewed separately from the trust. BNY Mellon I, 140 T.C. 15, 16 (2013). But the court reversed its holding on rehearing, and found that the loan should be respected as having economic substance. Bank of New York Mellon v. Comm'r, 106 T.C.M. (CCH) 367 (2013). The Second Circuit upheld the Tax Court's conclusion that the loan had sufficient economic substance. *See Bank of NY Mellon II*, 801 F.3d 104, 123-124. The *Salem I* court (like the Tax Court's original decision) also held that that the loan lacked economic substance, but the Federal Circuit reversed on this issue, holding that the loan should be respected. *See* Salem I, 112 Fed. Cl. at 587; Salem II, 786 F.3d 932, 958 (Fed. Cir. 2015). The government did not raise the issue of the loan's economic substance in *Santander III*, concentrating instead on the trust transaction. The *Santander III* court therefore did not analyze the loan. *See* Santander III, 844 F.3d 15 (1st Cir. 2016).

107 When the courts did an analysis in the alternative, treating the loans and the trust structure as one arrangement to be tested in the aggregate for economic substance, then the loan (as part of the entire transaction), was not respected as having economic substance (other than in the *Santander* lower court). *See Salem I*, 112 Fed. Cl. at 588-89; *BNY Mellon I* 140 T.C. at 48. Under that analysis, all U.S. tax effects of the loan, such as interest deductions, would have been disregarded. The loan, analyzed on its own, was respected (by the appellate courts), but it was not enough (when combined with the trust transaction) to save the trust transaction from economic sham treatment. Instead, if the loan and trust were analyzed together, the trust caused the loan to fail. This emphasizes that the important fact about the loan was that it was not the primary focus of the STARS transaction: the interest deductions were not the reason for the transaction (and would not have been enough to cause the transaction, since the detriment of the (above-market) interest paid by the U.S. bank is not sufficiently offset by the benefit of the deductions). This is consistent with case law precedent that treats as separable those parts of a transaction that were not crucial to obtaining the primary claimed U.S. tax benefits (here, the foreign tax credits), and that often respects those separable parts. *See, e.g.*, Rice's Toyota World, Inc. v. Comm'r, 752 F.2d 89, 96 (4th Cir. 1985); ACM P'ship v. Comm'r, 157 F.3d 231, 262-63 (3d Cir. 1998). In many of those cases, the separable transactions were loans, including loans that were incurred in order to engage in the economic sham transaction (unlike the STARS loans, where the loan funds were apparently used for other purposes, aside from the trust structure). *See, e.g.*, Rice's Toyota World, Inc. v. Comm'r, 752 F.2d 89, 96 (4th Cir. 1985).

C. Issues Relating to the Objective Analysis of Profit

1. Are Foreign Taxes a Cost?

a. Overview

Profit is an important component of the economic substance analysis, as described above. There has been some debate as to whether foreign taxes are a cost in computing such profit. Treating foreign taxes as a cost in measuring "profit" under the economic substance test is a clean, elegant solution—it makes the traditional profit analysis of the economic substance test easy to apply, and allows the economic substance test to reach the correct policy answer in foreign tax credit cases such as the STARS fact patterns. However, courts have been divided on this issue, with the STARS appellate courts finding that foreign taxes are treated as a cost, while the *Santander* lower court and two previous non-STARS cases (*Compaq* and *IES*) found that they were not. The Supreme Court has denied *certiorari* in three of the STARS cases, leaving a split between the circuits on this issue. After section 7701(o)'s effective date, the Treasury has the final say (because section 7701(o) directs it to issue guidance on the treatment of foreign taxes). But the Treasury has not issued regulations (or any other guidance) on the treatment of foreign taxes yet, more than seven years after 7701(o)'s enactment. As discussed below, it appears that foreign taxes are better treated as a cost for purposes of computing profit under the economic substance doctrine. This is a harder issue where the U.S. taxpayer (who is the subject of an economic substance challenge) does not bear the full economic burden of the foreign taxes.

b. Foreign Taxes Should be Treated as a Cost, and Why It Matters

i. Overview of the Profit Computation and Its Determination of Costs

As discussed above, the classic economic substance test considers two inquiries: an examination of the objective economic consequences of the transaction (often referred to as the "objective prong") and an analysis of the taxpayer's subjective business purpose (often referred to as the "subjective prong").[108] The objective inquiry depends largely on the question of whether the taxpayer reasonably expected to generate an economic profit (and how

[108] As previously mentioned, different circuits describe their versions of the economic substance test differently, but almost all of such descriptions include both of these factors. The First Circuit is an exception, stating in *Santander III* that it prefers not to examine subjective business purpose. *See* Santander III, 844 F.3d 15, 22 (1st Cir. 2016).

much).[109] This makes the measurement of "profit" very important.

"Profit" for purposes of the economic substance doctrine generally means reasonably expected net profit. In other words, it is based on gross income reduced by expenses, and it looks to the taxpayer's reasonable expectation rather than to actual results of the transaction.[110] Other aspects of the measurement of profit are less clearly delineated in the case law, but it appears that reasonably expected profit, for these purposes, is measured over the life of the transaction, not annually (unlike a tax return). The economic substance test also generally looks to the incremental profit from the transaction, without including profit the taxpayer would have earned even without the challenged transaction.[111]

Whether or not an item is deductible (or fully deductible) for U.S. federal income tax purposes should not necessarily determine whether the item is treated as an expense in computing profit for the economic substance test.[112] One could easily imagine a situation in which an economic cost is not deductible for U.S. federal income tax purposes—*e.g.*, due to capital loss rules,[113] or rules against deducting illegal bribes to foreign officials[114]—but is taken into account as a cost in computing "profit" for purposes of the economic substance test. The opinions in the STARS, *Compaq*, and *IES* cases do not discuss any taxpayer argument that "cost" is synonymous with deductions, and that therefore foreign taxes that were not deductible (because they were being claimed as credits rather than deductions) inherently could not be "costs." Nor should such an argument succeed.[115]

For all of the reasons described above, there may be differences

[109] The objective prong can also include analysis of whether the tested transaction was reasonably expected to cause a change in the taxpayer's objective economic circumstances, aside from profit. *See, e.g.*, BNY Mellon II, 801 F.3d 104, 119 (2d Cir. 2015); Salem II, 786 F.3d 932, 949 (Fed. Cir. 2015); *see also* 26 U.S.C. § 7701(o)(1)(A) (2016) ("[T]he transaction changes in a meaningful way (apart from federal income tax effects) the taxpayer's economic position.").

[110] *See, e.g.*, *Salem I*, 112 Fed. Cl. at 586 ("This inquiry focuses on what a reasonably prudent investor would have found from looking at the transaction prospectively."); Estate of Thomas v. Comm'r, 84 T.C. 412, 429, 437-38 (1985) (analyzing an investment in computer equipment and stating that "The fact that some 4 years later the bottom fell out of the used computer market does not alter the reasonable nature of the predictions in August 1975."); Jacobson v. Comm'r, 915 F.2d 832, 838-39 (2d Cir. 1990) (analyzing a film investment); *cf.* I.R.S. Notice 98-5, 1998-1 C.B. 334 (Jan. 20, 1998) (withdrawn).

[111] *See, e.g.*, *Salem I*, 112 Fed. Cl. at 586 ("Applying this test, courts have found that transfers of income-producing assets to controlled entities do not imbue an arrangement with substance if the transfer has no incremental effect on the taxpayer's activities.").

[112] *Cf.* I.R.S. Notice 98-5, 1998-1 C.B. 334 (withdrawn) (predicting that under future regulations, "In general, expected economic profit will be determined by taking into account expenses associated with an arrangement, without regard to whether such expenses are deductible.").

[113] *See* 26 U.S.C. §§ 165(f), 1211, 1212 (2016).

[114] *See* 26 U.S.C. § 162(c) (2016).

[115] A taxpayer generally cannot both deduct and credit foreign income taxes in the same tax year (with some exceptions). *See* 26 U.S.C. § 275 (2016). That fact should not have an impact on whether foreign taxes are treated as a cost for economic substance purposes. *See* Friendship Dairies, Inc. v. Comm'r, 90 T.C. 1054, 1065 (1988) (applying economic substance analysis to disallow an investment credit, and stating "[t]hat Congress chose to cast this tax incentive in the form of a credit rather than a deduction is immaterial").

between the computation of profit for the economic substance doctrine (which is economic profit, and is based on reasonable expectation and multi-year expected results) and the computation of taxable income for the taxpayer's tax return (which is an annual calculation, and takes into account the many federal tax rules about which items are deductible, to what extent, and when).[116]

For purposes of the economic substance test, the computation of "profit" does not treat the taxpayer's U.S. federal income tax as a cost, or U.S. tax benefits as income (including the U.S. federal income tax benefit that is being challenged as lacking economic substance).[117] For example, assume that a transaction consists of borrowing (or renting) and the government alleges that the interest (or rent) deduction should be disallowed because it lacks economic substance. In that case, "profit" for purposes of the economic substance test is determined by reference to reasonably expected gross income from the transaction less reasonably expected expenses (including the claimed rent or interest expense), but without regard to the benefit of the interest (or rent) deduction or the cost of any U.S. tax imposed on the transaction.[118]

The classic economic cases referred to "pre-tax profit,"[119] to make the point that "profit" was measured without regard to U.S. tax consequences. Before the *Compaq* and *IES* cases, no case had addressed whether foreign taxes are treated as a cost in computing profit under the economic substance

[116] Further, in each of the STARS transactions, gross income from the trust arrangement (the Bx payment) was received by the U.S. bank or its U.S. subsidiary, while the U.K. taxes (on the income from the trust's assets) were imposed on a U.K. subsidiary of the U.S. bank (the trustee). Nonetheless, the courts (other than the *Santander* lower court, which did not view the U.K. taxes as a cost) netted the Bx payment and the U.K. taxes against each other to compute profit (or loss) under the economic substance test, despite the fact that those amounts belonged to two separate entities (a U.S. person and a U.K. subsidiary, the trustee). The STARS taxpayers do not seem to have raised the argument that net "profit" should be determined only by reference to amounts that belonged to the U.S. taxpayers themselves, and not to their U.K. subsidiaries. This further underscores that "profit" in the economic substance calculation is an economic reality concept, rather than a determination of the taxpayer's taxable income under the technical federal tax rules. (This discussion assumes that the U.K. trustee was not treated as a disregarded entity for U.S. tax purposes, under the Treasury Regulations. *See* Treas. Reg. § 301.7701-3. That fact does not appear in the STARS opinions.) Similarly, the Fifth Circuit in *Compaq* performed a "profit" computation, for economic substance purposes, in which it subtracted a capital loss from a dividend (in a departure from the capital loss rules that would normally apply on a tax return computation). *See Compaq*, 277 F.3d at 786.

[117] *See infra* note 178. Alternative methods have been proposed by commentators. *See, e.g.*, Charlene D. Luke, *Risk, Return, and Objective Economic Substance*, 27 VA. TAX REV. 783, 785 (2008) (arguing that a post-tax (after U.S. tax consequences) measurement of profit, which could then be "compared to the return available on an economically equivalent market transaction" would be a better method of testing economic substance). However, such a test is likely precluded by section 7701(o), after that section takes effect. Section 7701(o)(1)(A) requires, in order for the objective prong to be met, 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) (2016) (emphasis added).

[118] *See, e.g.*, Goldstein v. Comm'r, 364 F.2d 734, 739-40 (2d Cir. 1966), *cert. denied* 385 U.S. 1005 (1967); Sheldon v. Comm'r, 94 T.C. 738, 762-64 (1990).

[119] *See, e.g.*, *ACM*, 157 F.3d at 258 & n.52 (3d Cir. 1998); Gefen v. Commissioner, 87 T.C. 1471, 1491 (1986).

test,[120] and no case had elaborated on whether "pre-tax profit" meant "pre-*U.S.*-tax" or "pre-U.S.-tax and pre-foreign-tax" profit.

ii. Treating Foreign Taxes as a Cost in the Profit Computation

a. In general

One of the main issues raised by the application of the economic substance doctrine to foreign tax credit fact patterns (including but not limited to the STARS transactions) is the question of whether foreign taxes are treated as a cost in measuring economic profit. Treating foreign taxes as a cost (or not) in measuring profit sometimes determines whether the taxpayer is treated as having reasonably expected a profit or a loss. That was the case in the *Compaq* and *IES* decisions, and also in the STARS fact patterns. This is a crucial question because profit is so central to the economic substance analysis: the measurement of reasonably expected economic profit often determines whether a transaction meets or fails the objective prong (and sometimes the business purpose prong as well, indirectly[121]), and thus often determines whether a transaction meets or fails the economic substance test.

This issue of the treatment of foreign taxes is sufficient, on its own, to show that the STARS transactions lack reasonably expected profit[122] and therefore fail the economic substance test.[123] In other words, if the foreign taxes are treated as a cost in computing profit, the government wins (unless the case is in a circuit that, before 7701(o), used the disjunctive test or the flexible approach, in which case the taxpayer could still prevail by winning the business purpose argument). The foreign taxes have such a large impact on the profit computation, in the STARS cases, because the trust's U.K. taxes (incurred by reason of the STARS transaction) in each case are roughly twice the size of the U.S. taxpayer's gross income from the trust transaction.[124]

---

[120] *See Compaq*, 277 F.3d at 785 n.7 (the government admitted that it had found no case addressing this issue).

[121] As applied, business purpose often depends largely on whether there was reasonably expected profit. *See* discussion *infra* Section III.D.

[122] Some circuits consider not only reasonably expected profit, but also whether there was any other potential economic effect. *See, e.g.*, BNY Mellon II, 801 F.3d 104, 119 (2d Cir. 2015); Salem II, 786 F.3d 932, 949 (Fed. Cir. 2015); *see also* 26 U.S.C. § 7701(o)(1)(A)(2016) ("[T]he transaction changes in a meaningful way (apart from federal income tax effects) the taxpayer's economic position."). But practically speaking, if there was no profit in the STARS cases, there was also no other potential change in economic circumstances, given the facts of the STARS transactions.

[123] As further discussed below, the government can win the objective prong issue if it wins either the argument that foreign taxes are treated as a cost or the argument that the Bx payment is not income. The taxpayer, in contrast, needs to win both such arguments in order to show that it meets the objective prong.

[124] The computation in the text focuses on the incremental income and costs caused by placing the U.S. bank's assets in the trust and appointing a U.K. trustee. It does not include the income that was already being generated by the U.S. bank's assets, and that would have been generated regardless of whether or not the assets were placed in the trust. For simplicity, this analysis also disregards the transaction costs incurred by the U.S. bank in entering into the trust transaction. Because the loan and the trust were generally viewed by the courts as two separate transactions, this computation also does not consider any economic detriment to the bank caused by borrowing from Barclays at a higher-than-market interest rate.

Therefore, if the foreign taxes are treated as a cost, the U.S. taxpayer has a reasonably expected economic *loss* from the STARS trust, and the loss is roughly equal to half the amount of the foreign taxes (and thus half the amount of the foreign tax credit claimed).[125] Conversely, if the foreign taxes are not a cost, then the U.S. taxpayer has a profit approximately equal to the Bx payment (which equals roughly half the amount of the foreign tax credit), if the Bx payment is income. Thus, the treatment of foreign taxes is the difference between profit and loss, and between meeting the economic substance test or not, in the STARS cases.[126]

b. Case Law Analyses and Section 7701(o)

The treatment of foreign taxes in the computation of "profit" for these purposes has a somewhat turbulent and convoluted history. The Tax Court in *Compaq* and the District Court in *IES* both treated foreign taxes as a cost in computing profit.[127] Therefore, those lower courts concluded that the respective taxpayers had no reasonably expected profit (which contributed to such taxpayers' failing the economic substance test, although the courts also considered the business purpose analysis). The Fifth and Eighth Circuits reversed the lower courts in *Compaq* and *IES*, respectively. Both of such circuits concluded that foreign taxes are not a cost in computing profit for purposes of the economic substance test.

For many years after these cases, no further governmental guidance––from any of the three branches of the Federal government––was provided on this question of the treatment of foreign taxes in applying the economic substance doctrine. Eventually, in 2010, Congress enacted section 7701(o). That section requires the Treasury to issue guidance providing that foreign taxes are treated as a cost in computing pre-tax profit, for purposes of the economic substance doctrine, "in appropriate cases."[128] Congress did not define such "appropriate cases" in section 7701(o). The Joint Committee on Taxation report on section 7701(o) gives little guidance on Congress' thinking on this issue, stating merely that "no inference" is intended as to the application of the economic substance doctrine before the effective date of section 7701(o) and "[t]here is no intention to restrict the ability of the courts

---

[125] The Bx payments in the STARS cases were approximately half of the foreign taxes paid on the trust's behalf, but the exact percentage relationship between the Bx payment and such U.K. taxes varied from case to case, possibly because of the different negotiating leverage of each of the U.S. taxpayers involved.

[126] One could imagine other fact patterns in which the foreign taxes were simply not large enough to make the difference, by themselves, between profit and loss, but perhaps such fact patterns can be expected to be rare among those transactions that are motivated primarily by the potential for foreign tax credits. Such credit-motivated transactions, by their nature, can be expected to involve very high amounts of foreign taxes, compared to the amount of gross income.

[127] Compaq Computer Corp. v. Comm'r, 113 T.C. 214 (1999), *rev'd* 277 F.3d 778 (5th Cir. 2001); IES Indus. v. U.S., 1999 U.S. Dist. LEXIS 22610, 2001-2 U.S. Tax Cas. (CCH) P50,470 (N.D. Iowa 1999), *rev'd* 253 F.3d 350 (8th Cir. 2001).

[128] *See* 26 U.S.C. § 7701(o)(2)(B).

to consider the appropriate treatment of foreign taxes in particular cases, as under present law."[129] The Treasury Department has so far declined to exercise its regulatory authority on this issue, even though more than seven years have passed since the enactment of section 7701(o).

Suddenly, the dormant issue of the treatment of foreign taxes as a cost (or not) reared its head again in the STARS cases. In particular, in footnote 9 of its *BNY Mellon I* opinion, the Tax Court announced that it still believed in its original decision (in *Compaq*) that foreign taxes are indeed a cost in determining profit under the economic substance analysis.[130] The Tax Court defiantly asserted that it would follow its original holding on this issue, rather than the contrary determination of two circuit courts (in *Compaq* and *IES*), except in cases appealable to the Fifth or Eighth Circuit.[131]

Of the courts that have opined on the STARS cases, four have held that foreign taxes are treated as a cost: *BNY Mellon I* (decided by the Tax Court), *BNY Mellon II* (in the Second Circuit), *Salem II* (in the Federal Circuit), and *Santander III* (in the First Circuit). Only one court (the District Court for the District of Massachusetts, in *Santander*) has held otherwise, and that holding was subsequently reversed by the First Circuit in *Santander III*. *Salem I*, surprisingly, did not discuss the issue of whether foreign taxes are a cost.[132] Because of its finding that the Bx payment was not income, the *Salem I* court reached the conclusion that the STARS transaction lacked profit without needing to opine on the treatment of the foreign taxes. In *Wells Fargo*, it is not totally clear how the jury decided on the issue. The court implies that the jury treated foreign taxes as a cost, because the jury's finding that the transaction lacked profit was attributable only "in part" to a finding that the Bx payment was not income.[133]

---

[129] *See* Staff of the Jt. Comm. on Tax'n, Technical Explanation of the Revenue Provisions of the Reconciliation Act of 2010, as Amended, in Combination with the Patient Protection and Affordable Care Act, JCX-18-10 at 155 and n. 357 (2010), available at http://www.jct.gov/publications.html?func=fileinfo&id=3673 (Joint Committee Report). The House of Representatives' version of section 7701(o) would have treated foreign taxes as a cost for purposes of computing profit under the economic substance test. *See* H.R. Rep. No. 111-443(I), at 61, 298 (2010), available at https://www.congress.gov/111/crpt/hrpt443/CRPT-111hrpt443-pt1.pdf (House Report). But that provision was changed before enactment.

[130] *See* BNY Mellon I, 140 T.C. 15, 35 n.9 (2013).

[131] *Id.*

[132] The taxpayer contended that the issue therefore could not be addressed by *Salem II* (because it was raised as a new issue on appeal). The *Salem II* court rejected this argument, concluding that "[t]he record shows, however, that the trial court treated BB&T's U.K. taxes as its 'out-of-pocket' cost in assessing the profit from the STARS transaction. Because the trial court addressed this issue, the government's argument [that foreign taxes are a cost in the profit computation] is properly before us." Salem II, 786 F.3d 932, 947 n.5 (Fed. Cir. 2015). The only text in the *Salem I* opinion that uses such phrasing about the trust's U.K. taxes is the following sentence, which appears in a discussion of whether or not the Bx payment is properly treated as income: "The Bx payment simply reimbursed BB&T for one-half of its out-of-pocket U.K. tax costs on the transaction." *Salem I*, 112 Fed. Cl. at 586. That is not quite a holding as to the treatment of foreign taxes in the profit computation under the economic substance analysis.

[133] *See Wells Fargo II*, No. 09-CV-2764, 2017 U.S. Dist. LEXIS 80401, 2017-1 U.S. Tax Cas. (CCH) P50,235 (D. MN. May 24, 2017) at 3 n.1.

Salem II treated foreign taxes as a cost after a lengthy discussion of the *Compaq* case and a conclusion that profit should be computed without regard to U.S. tax effects (including the foreign tax credit). The court stated that "[o]ur precedent . . . supports the government's approach, *i.e.*, to assess a transaction's economic reality, and in particular its profit potential, independent of the expected tax benefits."[134] It then concluded that the U.S. bank's "large foreign tax expense" exceeded its income from the STARS trust transaction, and "[t]he Trust transaction therefore is profitless . . . ."[135] It did not contain an in-depth analysis of why foreign tax effects are different from U.S. tax effects for purposes of the profit computation.

In *BNY Mellon I*, the Tax Court explained its reasoning as follows:

> 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 substantially all of the foreign taxes giving rise to the foreign tax credits stemmed from economically meaningless activity, i.e., the pre-arranged circular cash flows engaged in by the trust.
>
> 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.[136]

On appeal, the Second Circuit agreed, stating that:

> 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. . . . It is therefore appropriate for a court, when assessing the objective economic substance of a transaction, to include the foreign taxes paid but to exclude the foreign tax credits claimed in calculating pre-tax profit.[137]

The First Circuit (in *Santander III*) reached a similar conclusion,

---

[134] *Salem II*, 786 F. 3d at 948.

[135] *Id.* at 949. The court went on to examine whether the trust transaction "meaningfully alters the taxpayer's economic position (other than with regard to tax consequences)," declaring that the profit computation "does not by itself end the economic substance inquiry." *Id.* at 950. The court also found that the trust transaction did not meaningfully alter the U.S. bank's economic position (apart from the foreign tax credit). *Id.* at 950-51.

[136] *BNY Mellon I*, 140 T.C. at 35 n.9 (citation omitted).

[137] BNY Mellon II, 801 F.3d 104, 118 (2d Cir. 2015).

reversing the trial court. In *Santander*, the lower court ruled that the U.K. tax on the STARS trust was not a cost for purposes of the economic substance doctrine, for two reasons. First, it held that there was no net incremental increase in the U.S. bank's worldwide taxes by reason of the trust, because the tax amount owed to the U.K. increased, but the tax due to the U.S. decreased (because of the foreign tax credit) by the same amount. The taxpayer thus merely changed which country it paid tax to, not the net amount of its tax. Second, the *Santander* lower court followed the *Compaq* appellate court's reasoning that either all tax effects (U.S. and foreign) should be included in the profit computation, or all should be excluded—*i.e.*, U.S. and foreign tax effects should be treated identically to each other.[138]

The First Circuit reversed the lower court's decision, holding that foreign taxes are treated as a cost—on the STARS facts—for purposes of determining profit under the economic substance doctrine.[139] The appellate court appeared to leave open the possibility that foreign taxes might not be a cost in all circumstances. The court distinguished *IES* and *Compaq* on the grounds that they did not address STARS transactions and therefore were factually different from the present case. That reasoning does not seem quite persuasive, because the question of whether foreign taxes are a cost seems more like a theoretical and legal issue than a fact-dependent determination. The distinction of *IES* and *Compaq* on factual grounds is, however, consistent with the *Wells Fargo* special master's suggestion that perhaps the Eighth Circuit's view of foreign taxes as a cost was factually dependent, so that *IES* might not require ignoring the U.K. taxes as costs in the STARS cases.[140] The *Santander III* court also stated that it agreed with *Salem II*'s analysis of the issue of the treatment of foreign taxes as a cost in the profit computation. (*Salem II*, however, did not specify that its conclusion on the treatment of foreign taxes as a cost might change depending on the facts of particular cases.)

---

[138] Santander II, 144 F. Supp. 3d 239, 243 (D. MA. 2015).

[139] Santander III, 844 F.3d 15, 26 (1st Cir. 2016). The court stated that:

> Because exposure to U.K. taxation was the necessary and sufficient condition of the Bx payment, the U.K. taxes were an expense incurred by Sovereign for the "profit" generated by the Trust transaction. And when the U.K. taxes are recognized as expenses, there is no pre-tax profit, and the Trust transaction lacks a cardinal feature of an economically substantial transaction: a reasonable prospect of pre-tax profit.
>
> Sovereign and the district court rely heavily on *Compaq* and *IES* for the proposition that foreign taxes should not be treated as expenses. Santander II, 144 F. Supp. 3d at 242-44. Those cases did not analyze STARS transactions and so are distinguishable factually. We agree with the *Salem* court's analysis of this issue as to the Trust transaction. 786 F.3d at 947-49.
>
> Nor does our conclusion that Sovereign's U.K. taxes should be considered expenses contradict the Supreme Court's holding in *Old Colony*. *Old Colony* did not involve foreign taxes and says nothing about whether foreign tax liability may ever be considered an expense. *See Old Colony*, 279 U.S. at 716.

Id. at 24 n.11.

[140] *See* Wells Fargo & Co. v. United States, No. 09-cv-02764-PJS-TNL, 2011 U.S. Dist. Lexis 127976, at *15-16 (D. MN. Nov. 2, 2011).

The *Wells Fargo* jury found that the trust transaction lacked profit potential, but it is not clear whether the jury reached that result by treating the trust's U.K. taxes as a cost, or largely by declining to treat the Bx payment as income.[141] Earlier, the special master in that case denied the taxpayer's motion for summary judgement on the issue of ignoring foreign taxes as a cost.[142] The *Wells Fargo* court is bound to follow the Eighth Circuit, which held that foreign taxes were not a cost (in applying the objective prong of the economic substance test) in *IES*. However, the special master held that factual differences between the STARS transaction and *IES* might cause a different result in the two cases.[143] In particular, he noted that the *IES* court emphasized the presence of third parties who were acting in the normal course of their own businesses, and the use of arm's length pricing, neither of which are (arguably) present in the STARS cases. As he described it, *IES* also required an examination of all of the facts and circumstances, viewing the challenged transaction as a whole. This implies that a different result might be reached in other fact patterns, making summary judgement inappropriate in the view of the special master.[144]

Thus, the courts are now divided on this issue of the treatment of foreign taxes in applying the profit analysis of the economic substance doctrine. The Fifth and Eighth Circuits decided (in *Compaq* and *IES*, respectively) that foreign taxes are not a cost in computing "profit" for purposes of the economic substance test. The *Santander* lower court (in the District of Massachusetts) agreed in a STARS case, but was reversed. Other STARS opinions (by the First, Second, and Federal Circuits, and the Tax Court) held that foreign taxes are properly treated as a cost for purposes of the economic substance test's profit inquiry.[145] The Supreme Court has denied *certiorari* in three of the STARS cases,[146] leaving a split between the circuits

---

[141] *See* Wells Fargo II, No. 09-CV-2764 (D. MN. May 24, 2017) at 3, n. 1 (stating that "The jury's findings with respect to the trust structure depended *in part* on the jury's finding that the Bx payment was a tax benefit rather than an item of pre-tax revenue." (emphasis added)).

[142] *See* Wells Fargo & Co. v. United States, No. 09-cv-02764-PJS-TNL, 2011 U.S. Dist. Lexis 127976, at *12-16 (D. MN. Nov. 2, 2011).

[143] *See id.*; *see also* Wells Fargo & Co. v. United States, No. 09-cv-02764-PJS-TNL, 2014 U.S. Dist. Lexis 99111 at 43-46, 2014-2 U.S. Tax Cas. (CCH) P 50,372 (D. MN. 2014).

[144] *See* Wells Fargo & Co. v. United States, No. 09-cv-02764-PJS-TNL, 2011 U.S. Dist. Lexis 127976 at *14-16. It does not actually seem likely that factual differences between the STARS transaction and the *IES* transaction (purchase of stock with dividends, receipt of the dividends, and re-sale of the stock (without the dividend) to the original seller) would lead to a different answer on the question of whether foreign taxes are a treated as a cost. The treatment of foreign taxes in computing "profit" under the economic substance doctrine is a question of how the economic substance test is described, as a standard and a measuring tool, and it isn't immediately apparent why the definition of "profit" would vary in different fact patterns. It seems more likely that the government will lose the issue of the treatment of foreign taxes in *Wells Fargo* (on appeal), due to the application of *IES*, unless the Eighth Circuit decides to reconsider its previous position on this question. The government could nonetheless win on the objective prong on appeal (even if it loses the foreign-tax-as-a-cost-issue) if it wins regarding treatment of the Bx payment.

[145] *Pritired* applied the economic substance doctrine to foreign tax credits, but did not discuss arguments for and against treating foreign taxes as a cost. *See* Pritired 1, LLC v. United States, 816 F. Supp. 2d 693, 735-41 (S.D. Iowa 2011).

[146] *See supra* note 6.

on this issue (between the STARS appellate cases, on the one hand, and the *Compaq* and *IES* appellate cases on the other). Treating foreign taxes as a cost is fundamentally the same issue in the STARS cases as it was in *Compaq* and *IES*. The appellate courts in the two sets of cases disagree on this issue, and there does not appear to be any easy way to distinguish and harmonize them. Although the facts in STARS and the previous cases are different,[147] the legal question of whether foreign taxes are a cost in computing "profit" does not appear to depend on the facts of any specific case.[148]

In *Compaq* and *IES*, the Fifth and Eighth circuits (respectively) treated profit for economic substance purposes as meaning profit before all taxes—U.S. and foreign.[149] The *Compaq* court determined that U.S. and foreign tax consequences—both costs and benefits—should either all be included in the profit analysis, or all be excluded, as a matter of fairness.[150] Thus, it calculated that by ignoring foreign taxes as a cost, and also not taking U.S. tax credits or costs into account, the taxpayers had pre-tax profit for economic substance purposes. Similarly, the court reasoned that if foreign taxes were a cost for these purposes, then U.S. foreign tax credits should be treated as income and the U.S. tax imposed should be treated as a cost, leading to a net result of profit for economic substance test purposes.

In contrast, the *IES* court did not engage in much discussion of whether foreign taxes were treated as a cost or not. Instead, the court reasoned that the entire amount of the gross dividend was income to the taxpayer, and stated that "the economic benefit to *IES* was the amount of the gross dividend, *before the foreign taxes were paid*."[151]

Apart from a few general statements about fairness (in the *Compaq* opinion),[152] the *Compaq* and *IES* appellate opinions do not examine the reasons why U.S. and foreign tax should be treated differently from or

[147] In particular, the *Compaq* and *IES* cases lacked the cross-border arbitrage element of the STARS cases, nor did the *Compaq* and *IES* taxpayers receive a fee for acting as accommodation parties (as the STARS taxpayers did). *See* Compaq, 277 F.3d 778 (5th Cir. 2001); IES, 253 F.3d 350 (8th Cir. 2001). But these facts do not appear crucial to the question of whether foreign taxes of a U.S. person are treated as a cost in the economic substance analysis. In addition, *Compaq* and *IES* involved withholding taxes, and the U.K. taxes in STARS do not appear to have been collected by withholding. But that fact also does not seem to affect the cost issue (unless the withholding agent uses its own funds, not the taxpayer's, to pay the taxes, which did not occur in any of these cases).

[148] *But see* Wells Fargo & Co. v. United States, No. 09-cv-02764-PJS-TNL, 2011 U.S. Dist. LEXIS 127976, at *16 (D. MN. Nov. 2, 2011) (denying summary judgment to the taxpayer on the issue of whether foreign taxes are a cost, on the theory that *IES* may be distinguishable from the STARS cases on its facts). *See also supra* note 139 and accompanying text (discussing *Santander III* and its implication that facts might determine whether foreign taxes are treated as a cost).

[149] *See Compaq*, 277 F.3d at 784 ("Pre-tax income is pre-tax income regardless of the timing or origin of the tax." (citation omitted)); *IES*, 253 F.3d at 354.

[150] *See Compaq*, 277 F.3d at 785.

[151] *IES*, 253 F.3d at 354.

[152] *See Compaq*, 277 F.3d at 784. The *Compaq* opinion also contains brief computations of "pre-tax" and "post-tax" profit. *See id.* at 786.

identically to each other.[153] Instead, both opinions (especially *IES*) phrase the profit issue primarily in terms of how to compute gross income (income before any deductions), rather than focusing on whether the foreign taxes were a cost (an item subtracted from gross income to reach net income). Both courts emphasize the question of whether the taxpayers had gross income equal to the entire amount of the dividends they were owed (the gross dividends) or rather (as they said the government contended) gross income equal only to the net dividend (gross dividend less the foreign taxes that were withheld).[154] The question should have been, instead, not the amount of gross income (the start of the computation) but the expenses subtracted from that initial amount to reach net income (the next step in the computation).

One court quotes the government as arguing that the taxpayers bargained to receive only the net dividend (gross dividend less withholding tax).[155] It appears possible that the government was not speaking literally, but instead trying to describe the aggregate economic effect of the transaction. That effect was as follows: taxpayers purchased stock[156] (with a dividend already announced), immediately re-sold the stock to the same counterparty but retained the right to receive the dividend, and did receive the dividend. However, the portion of the dividend that was actually paid to the taxpayer was reduced by Dutch tax, which was withheld from the dividend by the payer. The counterparties (who sold the stock to the U.S. taxpayers) were not subject to U.S. tax (and were therefore unable to use a U.S. foreign tax credit or a U.S. deduction for foreign taxes), but the U.S. taxpayers (*Compaq* and *IES*) could use foreign tax credits (as well as capital losses from re-selling the stock for less than they paid for it). Therefore, the parties negotiated a purchase price with the view that the U.S. taxpayers would receive a dividend, but would also owe a foreign tax that could itself be used to generate a U.S. tax benefit. That was the economic reality of the transaction.

The technical tax result is that the U.S. taxpayers (*Compaq* and *IES*) had gross income equal to the entire dividend (un-reduced by the foreign tax),[157] even though the foreign tax was withheld and the taxpayers only received the gross amount less the foreign tax. Then the U.S. taxpayers were

---

[153] *See IES*, 253 F.3d at 354 (stating that the "economic benefit to IES was the amount of the gross dividend, before the foreign taxes were paid," without explaining why the foreign taxes should not be treated as a cost).

[154] *See IES*, 253 F.3d at 354 (stating that the "government would have us regard only 85% of the dividend as income to *IES*. . . ."); *Compaq*, 277 F.3d at 785.

[155] *See IES* at 354 ("According to the government's view of the transaction, 'IES purchased only the right to the net dividend -- not the gross dividend.'").

[156] Technically, the taxpayers purchased ADRs (American Depository Receipts), but these are referred to as stock in the text above, for simplicity.

[157] The Fifth Circuit notes several times that the entire gross dividend was required to be reported for accounting purposes, and was required to be treated as income for federal income tax purposes, while implying that these facts were contrary to the government's argument. *See Compaq*, 277 F.3d at 784 and n.2, 5.

able to claim either a deduction or a credit for the foreign tax.[158] If they had deducted the foreign tax, they would have subtracted the foreign tax from the previously computed gross income, resulting in net income (taxable income) from the dividend equal to (gross dividend less foreign tax). Alternatively, because they claimed a foreign tax credit for the Dutch tax, net income equaled the entire dividend (un-reduced by the foreign tax), and the amount of the foreign tax was subtracted from pre-credit U.S. tax (rather than from gross income).[159] (If the withholding tax had been a U.S. federal income tax rather than a foreign tax, no deduction or credit would have been allowed for U.S. federal tax purposes, although the gross income from the dividend would have been the same as above.)

The appellate *Compaq* and *IES* courts reason that the withholding agent's payment of the Dutch tax on behalf of the U.S. taxpayer (the dividend recipient) constituted additional income to the U.S. taxpayer.[160] The courts cite *Diedrich v. Commissioner*[161] (*Diedrich*) and *Old Colony Trust Co. v. Commissioner*[162] (*Old Colony*), both of which held that taxpayers recognize income when another person pays the taxpayers' obligation. What the *Compaq* and *IES* courts miss is that the taxpayers in their respective cases already had gross income equal to the entire gross dividend, under general principles, even without the application of *Diedrich* and *Old Colony*. Part of the taxpayers' own gross income (the dividend owed to them) was used by the withholding agent to pay the taxpayers' taxes. That payment did not constitute additional income to the taxpayers, because the withholding agent merely performed an administrative function and used the taxpayer's own funds. The U.S. tax result is thus the same as if the taxpayers had received the entire gross dividend and had themselves sent the Dutch tax to the Netherlands tax authorities.[163] *Old Colony* and *Diedrich* are not relevant because the withholding agents in *Compaq* and *IES* did not use the withholding agents' own funds to pay the taxpayers' Dutch tax.

Compaq also cites a net loan case, in which a borrower paid the lender's foreign tax from the borrower's own funds (not by withholding the

[158] *See* 26 U.S.C. §§ 164, 275, 901 (2016).

[159] These explanations, for both the deduction and foreign tax credit fact patterns, focus only on the dividend and the foreign tax, and ignore the capital loss and transaction costs that were also involved in the transaction, as well as the taxpayers' other items of income and expense.

[160] *See Compaq*, 277 F.3d at 784 (stating that "the payment of Compaq's Netherlands tax obligation by Royal Dutch was income to Compaq"); *IES*, 253 F.3d at 354 (reasoning that "In this case, income was realized by the payment of IES's foreign tax obligation by a third party.").

[161] 457 U.S. 191, 199-200 (1982) (holding that gift recipients' payment of donors' state and federal gift tax constituted income to the donors).

[162] 279 U.S. 716, 729 (1929) ("[D]ischarge by a third person of an obligation [of the taxpayer] . . . is equivalent to receipt by the [taxpayer] . . . .").

[163] But that general equivalence avoids the real question: although the answer is the same regardless of who actually mailed the Dutch tax to the Dutch authorities, are the Dutch taxes a cost that reduced the economic profit (the economic impact of the dividend) for the U.S. taxpayer?

tax from interest that was otherwise due to the lender).[164] In such a net loan situation, the foreign tax paid by the borrower was additional income to the lender (whose foreign tax had been paid). This situation is different from *Compaq* and *IES*, and from typical withholding situations, because the borrower used its own funds (not the lender's) to pay the tax, and the lender received both the gross interest payment and also the benefit of having its tax paid.

For example, in a net loan situation, if the interest due is $100 and the withholding tax is 20%, the lender receives the entire $100 from the borrower. In addition, the borrower pays $20 to the foreign country on the lender's behalf. The lender's total gross income is thus $120. The lender obtains the same tax result as if it had received both the gross interest payment and also the amount of the foreign tax, and as if it had then itself mailed the foreign tax amount to the foreign taxing authority. In *Compaq* and *IES*, in contrast, if the dividend owed had been $100 and the withholding tax had been 20%, the taxpayers would have received $80, and the other $20 of the taxpayer's gross dividend would have been used to pay the tax. The taxpayer's gross income (ignoring any other amounts, including other elements of the stock sale) would have been $100 (from the gross dividend). This is the same amount of income that would have resulted if the taxpayers had received the full $100 of the dividend and mailed $20 of that amount to the Dutch tax authorities to pay their Dutch taxes. (The examples in this paragraph do not show the potential impact – on net income - of choosing to deduct rather than credit foreign taxes for federal income tax purposes.)

In summary, although the *Compaq* and *IES* courts are correct that the entire gross dividend constitutes gross income to the taxpayers (the dividend recipients), they are wrong about the reasons why, and they miss the point that gross income is not the end of the inquiry.[165] The profit analysis under the economic substance test examines gross income *less expenses*, and the *Compaq* and *IES* cases (at the appellate level) spend too little time discussing why the foreign taxes should not be included among such expenses. *Compaq* says that all taxes should be treated identically (without explaining why U.S. and foreign taxes should be so treated).[166] Neither case addresses the fact that

---

[164] *See Compaq*, 277 F.3d at 784 (citing Riggs Nat'l Corp. v. Comm'r, 163 F.3d 1363, 1365 (D.C. Cir. 1999)).

[165] For example, the *IES* court concludes that the taxpayer had "profit" because the entire dividend constituted gross income. The court does not acknowledge the difference between gross income and profit: subtracting expenses from gross income to reach profit is the missing step in the opinion. *See IES*, 253 F.3d at 354.

[166] *See Compaq*, 277 F.3d at 785 (stating that "The Tax Court also erred by failing to include Compaq's $3.4 million U.S. tax credit when it calculated Compaq's after-tax profit. . . . If the effects of tax law, domestic or foreign, are to be accounted for when they subtract from a transaction's net cash flow, tax law effects should be counted when they add to cash flow. To be consistent, the analysis should either count all tax law effects or not count any of them."). However, the government was not arguing for a distinction between tax benefits and tax costs, but instead for a distinction between U.S. and foreign income tax effects – presumably without regard to whether such tax effects were costs or benefits. For example, foreign tax

Federal income tax law often treats foreign and U.S. taxes differently from each other.[167] In particular, these opinions fail to address the economic substance case law's clear mandate to determine what remains of expected profit and of business purpose when U.S. tax effects are removed from the equation. Instead, the *Compaq* court includes U.S. tax effects in a "post-tax" profit equation, treating U.S. foreign tax credits as income (contributing to profit) and the U.S. tax as a cost.[168] In that computation, the Fifth Circuit finds that there is profit[169], which functionally occurs because of the U.S. foreign tax credits (which far outweigh the additional U.S. tax costs of the transaction).[170] The Fifth Circuit also computes a "pre-tax" profit by ignoring the Dutch tax (and the U.S. tax costs and credits). The *IES* opinion, in contrast, lacks such detailed computations, and merely states that the entire gross dividend (without reduction for foreign tax) constitutes an "economic benefit."[171]

The courts and the government have struggled with analyzing this issue of the treatment of foreign taxes.[172] One major obstacle is that the pre-

benefits (for example, a credit or deduction granted under foreign law) presumably might have increased the economic profit, measured for economic substance purposes, under the government's approach. (Former Notice 98-5, however, suggested a different approach: "it is inappropriate in the context of the U.S. foreign tax credit system to allow foreign tax credits with respect to abusive arrangements simply because the arrangements generate substantial foreign tax savings. Accordingly, the regulations will provide that the calculation of expected economic profit will not include expected foreign tax savings attributable to a tax credit or similar benefit allowed by a foreign country with respect to a tax paid to another foreign country." Notice 98-5, withdrawn.)

[167] The Fifth Circuit said that "That the tax was imposed by the Netherlands rather than by the United States . . . is irrelevant to how the part of the dividend corresponding to the tax should be treated for U.S. income tax purposes." *Compaq*, 277 F.3d at 784. That conclusion is literally untrue: the Dutch taxes can be used as a U.S. tax deduction against income, resulting in less net income from the dividend (if the taxpayer chooses to deduct such taxes rather than claiming foreign tax credits). *See* 26 U.S.C. §§ 164 (2016) (allowing deductions for foreign taxes), 275 (providing that the deduction for foreign income taxes is not available if the taxpayer claims foreign tax credits). U.S. federal income tax, in contrast, is not deductible against the gross dividend amount, because federal income taxes are treated differently from foreign (and state and local) taxes for purposes of computing federal taxable income.

[168] *See Compaq*, 277 F.3d at 786 ("If the effects of the transaction are computed consistently, Compaq made both a pre-tax profit and an after-tax profit from the ADR transaction. Subtracting Compaq's capital losses from the gross dividend rather than the net dividend results in a net pre-tax profit of about $ 1.894 million. Compaq's U.S. tax on that net pre-tax profit was roughly $ 644,000. Subtracting $ 644,000 from the $ 1.894 million results in an after-tax profit of about $ 1.25 million. The transaction had economic substance.").

[169] *See id.*

[170] *Contra* Salem II, 786 F.3d 932, 948 (Fed. Cir. 2015) ("And the fact that the transactions produced a net gain to the taxpayer after taking both the foreign taxes and the [U.S.] foreign tax credit into account says nothing about the economic reality of the transactions, because all tax shelter transactions produce a gain for the taxpayer *after* the tax effects are taken into account—that is why taxpayers are willing to enter into them and pay substantial fees to the promoters." (emphasis added)). *See also* Bryan Camp, *Form Over Substance in Fifth Circuit Tax Cases*, 34 TEX. TECH. L. REV. 733, 753 (2003).

[171] *See IES*, 253 F.3d at 354.

[172] Commentators have also differed on the appropriate treatment of foreign taxes in the economic substance analysis. Some have argued that such taxes should be treated as costs in computing profit. *See, e.g.*, Daniel N. Shaviro & David A. Weisbach, *The Fifth Circuit Gets It Wrong in Compaq v. Commissioner*, 94 Tax Notes 511, 515 (Jan. 28, 2002). Others have felt strongly that foreign taxes should not be treated as costs for these purposes. *See, e.g.*, Kevin Dolan, *The Foreign Tax Credit Diaries – Litigation Run Amok*, 71 TAX NOTES INT'L 831, 839 (2013); Richard M. Lipton, BNY & AIG–*Using Economic Substance to Attack Transactions the Courts Do Not Like*, 119 J. TAX'N 40, 46 (2013).

Compaq, pre-*IES* case law on the economic substance doctrine refers to "pre-tax profit," rather than "pre-*U.S.*-tax profit."[173] Taxpayers have argued that the reference to "pre-tax" profit means that all taxes—including foreign taxes—are excluded from the profit computation.[174] But foreign tax just was not relevant before, because it was not presented in any of the fact patterns that the earlier cases addressed.[175]

In order to adapt the classic articulations of the economic substance doctrine to modern facts involving cross-border transactions, the courts merely need to clarify that "pre-tax" profit means "pre-*U.S.*-tax" profit. The appellate opinions in the STARS cases have reached that conclusion, as did *BNY Mellon II*'s discussion of *AIG*, but the appellate decisions in *Compaq* and *IES* said otherwise.

For the future, section 7701(o) provides regulatory authority and some textual hints regarding the treatment of foreign taxes. Section 7701(o) requires the Treasury to issue regulations that treat foreign taxes as a cost (for economic substance purposes) "in appropriate cases."[176] It does not describe what such appropriate situations might be (or which fact patterns might *not* be appropriate for such treatment). The Treasury has not yet issued regulations on this issue.

Section 7701(o) also may strengthen the argument that foreign taxes are a cost, even in the absence of such regulations, because it describes the objective and subjective prongs as being determined "apart from *Federal* income tax effects" rather than "apart from tax effects."[177] Section 7701(o) may thus be read as implying that objective consequences and subjective business purpose are both determined by taking into account foreign tax items.

c. Foreign Taxes Should be Treated as a Cost for Economic Substance Purposes

On balance, foreign taxes should be treated as a cost for purposes of the profit computation (even before the Treasury Department issues guidance on this issue under section 7701(o)) for two main reasons (in addition to the underlying fact that foreign taxes are an economic reduction of wealth). First,

---

[173] *See, e.g.*, *ACM*, 157 F.3d at 258 & n.52 (3d Cir. 1998); Gefen v. Commissioner, 87 T.C. 1471, 1491 (1986).

[174] *See, e.g.*, *Compaq* 277 F.3d at 784 (using such an argument).

[175] *Fox v. Commissioner* and the cases that reviewed it did examine straddle transactions that occurred on foreign markets, but those cases were only concerned with the U.S. deductions relating to those transactions, and did not consider any foreign taxes imposed on the taxpayers. *See* 56 T.C.M. (CCH) 863 (1988), *supp'l op.* Kazi v. Commissioner, T.C. Memo 1991-37, 61 T.C.M. (CCH) 1759; *aff'd* Gardner v. Commissioner, 954 F.2d 836 (2d Cir. 1992), *cert. denied* Falk v. Commissioner, 504 U.S. 910 (1992); *rev'd* Horn v. Commissioner, 968 F.2d 1229 (D.C. Cir. 1992).

[176] 26 U.S.C. § 7701(o)(2)(B) (2016).

[177] *See id.* § 7701(o)(1)(A)–(B) (using the same phrase, "apart from Federal income tax effects" when describing the objective and subjective prongs, respectively) (emphasis added).

the objective prong essentially solves for the non-U.S.-tax-effect aspects of a transaction, removing U.S. tax benefits from the profit equation to determine whether any profit (or other economic effect) remains aside from such tax benefits. Second, foreign tax (like state tax) is inherently different from U.S. federal income tax for purposes of federal income tax policies and rules. Both arguments are further discussed below.

First, the point of "pre-tax" profit is to remove the item being tested–the U.S. tax benefit being challenged under the economic substance doctrine—from the profit computation, in order to determine whether sufficient substance remains without the challenged U.S. tax benefit.[178] U.S. tax costs are also removed, presumably because they (in effect) offset the value of the challenged U.S. tax benefit and contribute to the net U.S. tax effect, all of which is excluded from pre-tax profit. These rationales do not apply to tax benefits or costs created under foreign law: benefits granted under foreign law are not the items being challenged under the economic substance doctrine, and therefore the profit calculation does not "solve for" non-foreign-tax effects. For that reason, foreign tax costs need not be excluded in order to be sure that the net effect of any such foreign tax benefits is removed from the profit calculation.

Second, a bedrock principle of U.S. federal income tax is that U.S. income tax is unique in the income tax computation—it is treated differently from other accessions to wealth and other expenses, and differently than foreign or state tax. That is why, for example, U.S. federal income tax rules allow a credit or deduction for foreign income taxes,[179] and a deduction for state taxes,[180] but no credit or deduction for U.S. federal income taxes themselves.[181]

In analyzing the appropriate treatment of foreign tax costs, there is a clear analogy to the treatment of state tax costs. Unfortunately, there is not much judicial (or other) guidance that addresses the treatment of state tax costs (or benefits) in an economic substance analysis of federal tax benefits. There is a strong argument, however, that state tax benefits and costs should

---

[178] *See, e.g.*, Salem I, 112 Fed. Cl. 543, 586 (2013) ("Courts must isolate tax effects and examine the aspects of the transaction that are economically substantive absent the tax."); IRS v. CM Holdings, Inc., 301 F.3d 96, 103 (3d Cir. 2002) (stating that "The main question these different formulations [of the objective prong] address is a simple one: *absent the tax benefits*, whether the transaction affected the taxpayer's financial position in any way." (Emphasis added)); Friendship Dairies, Inc. v. Comm'r, 90 T.C. 1054, 1061 (1988) (opining that the investment tax credit could not be treated as profit for purposes of the economic substance analysis, because such profit is measured without regard to U.S. tax effects).

[179] *See* 26 U.S.C. § 901 (2016) (providing for credit for foreign income taxes); *id.* § 164 (providing for deduction for foreign income taxes).

[180] *See id.* § 164.

[181] Section 164 allows a deduction for federal generation-skipping transfer tax, which is not (generally speaking) an income tax (because it is imposed on the transfer of wealth, rather than on income generated during the taxable year). *See id.* §164(a)(4), (b)(4)(A). In some previous years, there was a deduction for the environmental tax imposed under section 59A, but that environmental tax (and the deduction) have been repealed. *See id.* former §§164(a)(5), 59A (both repealed).

be included in the computation of profit (in an economic substance challenge to U.S. federal income tax benefits) because state taxes are not the items that need to be removed from the computation to see if sufficient substance remains without them.[182]

For transactions after March 30, 2010, section 7701(o) creates an interesting negative inference: it provides that state tax effects are not taken into account for the economic substance analysis (for either the objective or subjective prong) if they are related to Federal income tax effects.[183] This implies that any state tax effects that are not so related *are* income (or costs) for such purposes, and that it requires a specific rule to exclude state taxes that are so related. Section 7701(o) also treats U.S. and foreign taxes differently from each other, by excluding U.S. federal income tax effects from the objective and subjective analyses, but providing that the Treasury shall issue guidance to treat foreign taxes as costs "in appropriate cases."[184] These distinctions between U.S. federal income tax effects and other types of tax effects (both state and foreign) support the argument that U.S. federal income tax effects are unique.

Similarly, reducing state or foreign tax has been treated as a business purpose (depending on the circumstances) in other contexts, in contrast to saving U.S. federal income tax.[185] This bolsters the point that state and foreign tax effects are treated differently than U.S. federal tax effects.

Taxpayers could also argue that foreign taxes, unlike state taxes, are

---

[182] *See* 26 U.S.C. § 7701(o)(3) (2016) (implying that state tax effects are taken into account in the economic substance analysis unless such state tax effects are "related to a Federal income tax effect"); *cf.* Salem II, 786 F.3d 932, 953 n.8 (Fed. Cir. 2015) (rejecting an argument that the U.S. bank's state tax savings were relevant profit, not because state tax savings cannot be counted as income but because the state tax savings resulted from a different transaction (a transfer of the trust's assets from one state to another), which implies that state tax savings from the challenged transaction could be taken into account in computing profit).

[183] *See id.* ("For purposes of paragraph (1) [which lists the two prongs of the economic substance test], any State or local income tax effect which is related to a Federal income tax effect shall be treated in the same manner as a Federal income tax effect.").

[184] 26 U.S.C. §§ 7701(o)(1), 7701(o)(2)(B) (2016).

[185] *See* Rev. Rul. 89-101, 1989-2 C.B. 67 (stating that "substantial reduction in the amount of foreign withholding tax imposed on FY will benefit the worldwide operations of the affiliated group that includes FX, FY, and P. Therefore, the distribution by FX to P of all the FY stock is carried out for a purpose germane to the business of the affiliated group within the meaning of section 1.355-2 (b) (2) of the regulations."); Rev. Rul. 76-187, 1976-1 C.B. 97 (reducing state and local taxes can be a business purpose under the section 355 rules); Treas. Reg. § 1.355-2(b)((2) (demonstrating that reducing "non-Federal" tax can be a sufficient business purpose under certain section 355 rules, unless such reduction is both connected with and too sizable compared to a reduction in federal taxes); T.D. 8238, 1989-1 C.B. 92 (explaining that, in the context of the section 355 regulations, "The Internal Revenue Service has ruled that reduction of state and local capital taxes is a corporate business purpose. . . . That rule will remain in effect. However, Treasury and the Internal Revenue Service continue to believe that reduction of Federal taxes should not be regarded as a corporate business purpose."); *see also* Del Commer. Props. v. Comm'r, 251 F.3d 210, 216 (D.C. Cir. 2001) (describing the parties' arguments regarding foreign tax savings as a business purpose, and stating that "The Commissioner does not concede that foreign tax avoidance is a legitimate business purpose, and we do not need to address that question here. While perhaps not directly applicable to this case, Treasury Regulation § 1.355-2(b) is instructive."); *but cf.* Notice 98-5 (withdrawn) (suggesting a different approach, at least for some foreign law benefits).

meant to be treated identically to U.S. income taxes under the foreign tax credit regime. But that argument is not quite convincing. Under the U.S. tax system, foreign income taxes can be either credited or deducted, unlike U.S. income taxes themselves. Further, credits for foreign taxes can only be applied in a manner limited by hundreds of pages of detailed code and regulatory rules, rather than being used as a fungible amount against any and all U.S. income tax costs. For example, foreign taxes may only be used as a credit to the extent of U.S. tax on foreign source taxable income in a particular separate limitation category ("basket").[186]

In addition, taxpayers could argue that the foreign tax credit was meant to prevent foreign taxes from being an economic cost, because it was intended to ameliorate double taxation (the imposition of both U.S. and foreign tax on certain items of the same income). They could contend that the intent of the foreign tax credit statutes therefore requires that foreign taxes not be treated as a cost in the economic substance analysis. (Statutory intent is important because "the thing which the statute intended"[187] is the underlying point of the economic substance doctrine, as noted earlier.) However, the foreign tax credit technically operates (when it applies) to allow foreign tax to be an economic cost and to instead prevent U.S. tax from functioning as an economic cost. In particular, the foreign tax credit carries out a policy of ceding primary taxing jurisdiction on certain foreign source income to the foreign country of source[188] (*i.e.*, allowing the foreign tax to be an economic cost, and removing an amount of U.S. tax).

Even that policy summary is an oversimplification: the entire foreign tax remains an economic cost, and U.S. tax is imposed to the extent that it

[186] *See* 26 U.S.C. § 904(a), (d) (2016).

[187] *See* Gregory v. Helvering, 293 U.S. 465, 469 (1935).

[188] Generally, the foreign tax credit is intended to cede primary taxing jurisdiction on foreign source income to the foreign country where the income is generated, while reserving the right to impose "residual U.S. tax" on such income if the foreign tax is lower than the pre-credit U.S. tax. For example, assume that foreign country X imposed 20 of tax on 100 of foreign source income, and U.S. law imposed 35 of federal income tax on the same income. Assuming that all other requirements for the foreign tax credit were met, the U.S. would allow a credit of 20 against its tax (ceding primary taxing jurisdiction on such income to country X), and would collect the remaining 15 (the excess of the 35 of U.S. tax over the 20 of foreign tax, or the "residual U.S. tax").

Conversely, the U.S. does not cede primary taxing jurisdiction on U.S. source income. In theory, if foreign country X imposed 20 of tax on U.S. source income of 100, and the U.S. imposed 35 of tax on the same income, the U.S. would collect its full 35 of U.S. federal income tax on the income, and would leave it to the foreign country to allow a credit, deduction, or other relief against the foreign tax. (This is one reason why the STARS taxpayers claimed that the income from their trust assets was foreign source rather than U.S. source.) This concept of allowing a foreign tax credit only against the U.S. tax on foreign source income is implemented in section 904(a) of the Code, through the "foreign tax credit limitation fraction." *See* 26 U.S.C. § 904(a). That rule provides that the foreign tax credit is limited to the lesser of foreign income tax paid (or accrued) or the result of the following computation: U.S. tax x (foreign source taxable income/worldwide taxable income). *Cf.* Stuart Leblang & Rebecca Rosenberg, *Toward an Active Finance Standard for Inbound Lenders*, 31 TAX MGM'T. INT'L J. 131, 132 (2002) (discussing policies of ceding primary taxing jurisdiction with respect to some types of income and retaining primary jurisdiction with respect to other income).

exceeds the foreign tax.[189] Conversely, foreign tax that exceeds U.S. tax is theoretically unable to offset any U.S. tax, and such excess remains a cost without generating any useful benefit from a foreign tax credit (although such excess can be carried over to other years).[190] Thus, the foreign tax credit is not meant to prevent foreign taxes from being an economic cost—it is meant to prevent foreign and U.S. income taxes from being *duplicative* costs. The mechanics and policies of the foreign tax credit essentially have U.S. taxpayers pay a net amount equal to the greater of U.S. or foreign income tax (but not the *sum* of U.S. income tax plus foreign income tax) on each separate category ("basket") of foreign source income. Therefore, there is no intent to prevent foreign tax from functioning as a cost.

In summary, foreign taxes should be treated as a cost in computing profit under the economic substance doctrine, despite a lack of detailed authority on the computation of profit or on treatment of state taxes (which would be a useful analogy). Such treatment as a cost is consistent with the economic substance doctrine's general approach of evaluating what remains of a transaction apart from U.S. federal income tax effects. In addition, U.S. and foreign taxes are not usually treated as interchangeable items for U.S. federal income tax purposes. There are few good arguments to the contrary, against treating foreign taxes as a cost for economic substance purposes, other than a contention that earlier court cases that addressed purely domestic fact patterns should be read as opining (inadvertently) on foreign taxes when they referred to "pre-tax profit" (rather than "pre-*U.S.*-tax profit"). Arguments that the foreign tax credit system does not treat foreign taxes as a cost are unpersuasive. After the STARS cases, there is currently a split in circuits concerning the treatment of foreign taxes as a cost, but *Compaq* and *IES* appear to be wrong on this issue. The Supreme Court has denied *certiorari* in three of the STARS cases, and there is no guidance from Treasury or the IRS under section 7701(o) on the treatment of foreign taxes as a cost. Therefore, the treatment of foreign taxes in the economic substance analysis continues to be a live and contentious issue.

iii. Relevance of Economic Burden

In debating whether foreign taxes should be included in the profit computation, all of the above implicitly assumes that the foreign taxes are an economic cost to the taxpayer (at least before the application of the foreign tax credit). The question of whether foreign taxes should be treated as a cost (for purposes of the economic substance test) is more nuanced and more

---

[189] *See supra* note 188 (discussing residual U.S. tax).

[190] *See* 26 U.S.C. § 904(c) (2016) (providing a 1-year carryback and a 10-year carryforward of foreign taxes, if they cannot be credited in the year paid or accrued by reason of the foreign tax credit limitation fraction). In addition, the discussion in the text above focuses on the theory, without delving into the details of cross-crediting foreign taxes on one item of income against the U.S. tax on unrelated items of foreign source income in the same limitation category ("basket"). *See generally* 26 U.S.C. § 904(d) (2016).

difficult if the taxpayer does not bear the economic burden of the foreign tax, *e.g.*, if a counterparty pays the foreign tax out of its own funds. This issue is present, indirectly, in the STARS cases: even though Barclays did not pay the trust's tax directly to the U.K. (on the trust's behalf), Barclays did reimburse the U.S. bank for part of the U.K. tax (by means of the Bx payment, computed as a percentage of the U.K. tax). The U.S. bank and its subsidiaries therefore did not economically bear the full burden of the U.K. tax, after the Bx payment was taken into account. The STARS courts do not discuss the conceptual problems raised by treating the U.S. banks as bearing 100% of a cost that was effectively (by means of contract terms that provided for the Bx payment) partly borne by Barclays.[191]

If the economic substance test's measurement of profit is based on economic reality, rather than availability of deductions, then there is a conceptual question about whether foreign taxes for which a taxpayer does not have the economic burden (*e.g.*, which are paid by or reimbursed by a counterparty) should be treated as a cost.[192] But, functionally, this issue (treatment as a cost in the absence of economic burden) appears to be solved by the basic *Old Colony* concept that one party's payment of another party's obligation results in income to the latter.[193] When such income is taken into account in computing profit for purposes of the economic substance test, it can be effectively netted against the cost of the foreign tax to leave no net economic cost (and no profit for purposes of the economic substance test), if 100% of the tax is paid by the counterparty. In theory, that is the correct result in computing the economic effect for purposes of applying the economic substance test: no net cost because the taxpayer does not bear the economic burden of the tax, and no net increase in income because the income created by the counterparty's payment of foreign tax on the taxpayer's behalf is offset by the cost of the foreign tax.[194] The results when the counterparty pays or

[191] In *Salem II*, the taxpayer argued that if the Bx payment was a rebate, it was only a rebate of 51% of the U.K. tax, and that the taxpayer should therefore still get a credit for the remaining 49%. *Salem II*, 786 at 955, n.9. But that was not an argument that the portion of the foreign tax for which the taxpayer did not bear the economic burden should not be treated as a cost (for purposes of computing profit).

[192] Note that it's a little odd, from a policy perspective, that taxpayers could claim a foreign tax credit for foreign taxes for which they do not bear the economic burden. But the Treasury Regulations allow this result. Those regulations provide that the person who has "legal liability" for a foreign tax, under foreign law, is treated as paying or accruing the tax for purposes of the U.S. foreign tax credit (with a few specific exceptions). Treas. Reg. § 1.901-2(f)(1), (3)–(4) (2016). Thus, it is possible for a taxpayer to argue both that foreign taxes are not a cost for purposes of computing profit under the economic substance test, and that it, nonetheless, deserves a foreign tax credit for such "non-cost" foreign taxes.

[193] *See* Old Colony, 279 U.S. 716, 729 (1929).

[194] This is not necessarily the same result as the federal income tax computation of taxable income. Generally, a taxpayer whose foreign tax is paid by another person (from such other person's funds) has gross income in the amount of such payment, under *Old Colony* principles. *See id.*, *see also, e.g.*, *Nissho Iwai*, 89 T.C. at 772-73; Cont'l Ill. Corp. v. Comm'r, 998 F.2d 513, 516 (7th Cir. 1993). The question raised in the text is how such gross income nets (in effect) against the treatment of foreign taxes as a cost, for purposes of computing profit under the economic substance analysis. The point of the economic substance doctrine's analysis of the objective prong is not to mirror the results of the taxpayer's federal income tax form, but to evaluate the extent of the economic impact (reasonably expected, over time) of a transaction other than the effect of U.S. tax consequences. For that reason, section 7701(o)'s iteration of

reimburses only a portion of the taxpayer's foreign tax (as in the STARS cases) would be more graduated, corresponding to the fact that the taxpayer bore a net cost of less than all of the foreign tax.

Practically speaking, instances in which a taxpayer (or its foreign subsidiary) has the legal liability for a foreign tax (required for a foreign tax credit)[195] but not the full economic burden appear to be limited to situations in which another party (partially or fully) either pays the foreign tax to the foreign country on the taxpayer's behalf (out of the counterparty's own funds), or reimburses the taxpayer (directly or through favorable contract terms) for the foreign tax.[196] In either case, there is income to the person with legal liability, by reason of the other person's payment. In the STARS cases, for example, Barclays paid the Bx payment to the U.S. bank rather than paying a percentage of the trust's tax directly to the U.K. The parties had the same economic effects, however (before additional U.S. and U.K. tax effects), as if Barclays had paid approximately 50% of the trust's U.K tax directly to the U.K. on the trust's behalf. While there were likely U.K. tax reasons for choosing the Bx payment's form, one could easily imagine future fact patterns in which the counterparty pays the U.S. person's tax directly to the foreign government (from the counterparty's own funds), especially if there were an argument that such a structure could avoid treating foreign taxes as a cost for economic substance purposes (on a theory of lack of economic burden).

One could also imagine transactions in which the benefit of the counterparty's paying the taxpayer's tax is counterbalanced by other transaction terms. In that situation, the taxpayer does bear the economic cost of the amount of the foreign taxes, even though such cost is borne indirectly, in the form of other contract terms (*e.g.*, price per unit, or rental costs) that are less favorable to the taxpayer than they otherwise would be. For example, the *Amoco* court reasoned that Amoco received a lower price per barrel to offset the benefit of the counterparty's paying Amoco's Egyptian taxes, and that Amoco therefore actually bore the economic burden of such Egyptian taxes.[197]

In contrast, one could imagine net transactions in which the counterparty pays the taxpayer's foreign taxes (from the counterparty's own funds) and bears the risk of such foreign taxes rising or falling, although the

---

the objective prong, and its limitation on when profit can be taken into account for the objective and subjective prongs, do not mimic the taxpayer's federal income tax return result in all respects. *See generally* 26 U.S.C. § 7701(o).

[195] Treas. Reg. § 1.901-2(f)(1) (2016); *see generally* 26 U.S.C. §§ 901, 960(2016).

[196] Note that if the foreign tax is never paid—*i.e.*, neither the taxpayer nor anyone else pays the tax—then no foreign tax credit is allowed. *See* 26 U.S.C. §§ 901 (providing for a credit for foreign taxes paid or accrued), 905(c)(1)(B), (2) (2016) (disallowing credits for accrued foreign taxes not paid within two years of the year to which they relate, although such credits may be claimed later when the taxes are paid).

[197] *See* Amoco, 138 F.3d 1139, 1149 (7th Cir. 1998) (stating that "Amoco unquestionably bore the economic burden of the taxes imposed on its operations by Egypt. This means that it does no violence to the tax laws to construe them as allowing Amoco to take the foreign tax credit under these circumstances.").

contract terms are the same as those between other parties who are not paying each other's taxes.[198] One would expect this type of net arrangement only where the tax-paying counterparty lacks bargaining power, as in *Nissho Iwai* and other Brazilian net loan cases. In such situations, the taxpayer appears *not* to bear any of the economic burden of the foreign taxes, even indirectly.[199]

All of the situations above (in which another person pays or reimburses the taxpayer's obligation out of such other person's funds) differ from the classic withholding fact pattern, in which the withholding agent uses the taxpayer's own funds to pay foreign tax on the taxpayer's behalf. In the latter case, the withholding agent is merely performing an administrative function, without creating additional income to the taxpayer.[200]

In all of these types of fact patterns, the correct result in the economic substance doctrine's profit computation appears to be reached if the foreign taxes are treated as a cost (because they are the taxpayer's legal obligation) and the counterparty's reimbursement to the taxpayer or direct payment of the foreign taxes is treated as income to the taxpayer (under general tax rules or under *Old Colony*[201] and similar authorities, respectively). Under that approach, the cost and the income can be netted against each other for purposes of the economic substance test's profit computation (even if not for federal income tax return purposes). This results in the appropriate (economic) reflection of the taxpayer's net cost or burden for the foreign taxes (zero if the counterparty pays the entire foreign tax) for purposes of the economic substance analysis.

Where a counterparty pays (or reimburses for) the foreign tax, netting the resulting income against the foreign tax cost (for economic substance purposes) should reflect the economic effect of the foreign taxes on the taxpayer. In other patterns described above, less favorable contract terms result in lower net income for the taxpayer, reflecting the fact that the taxpayer functionally bore the economic burden for the foreign taxes. In the net transaction cases that do not present such terms, the zero net income (and zero net cost) from netting income (caused by the counterparty's payment of the taxpayer's taxes) against foreign taxes (for economic substance purposes) reflect economic reality, because the taxpayer is economically indifferent to the amount of the foreign taxes (and is also indifferent to the amount of the

198 *See, e.g., Nissho Iwai*, 89 T.C. at 767; Riggs Nat'l Corp. v. Comm'r, 163 F.3d 1363 (D.C. Cir. 1999).

199 One could argue, as in *Amoco*, that the taxpayer must bear the economic burden for the foreign taxes somehow, even if indirectly, through other contract terms. *See* Amoco, 138 F.3d 1139, 1149 (7th Cir. 1998). But that apparently was not true of *Nissho Iwai*. The *Nissho Iwai* court referred to the foreign tax credit as a windfall, presumably because none of the economic cost of the foreign taxes was borne by the U.S. taxpayer in that case. *Nissho Iwai*, 89 T.C. at 776. Moreover, the STARS taxpayers appear to have borne only part (and not all) of the economic burden of the taxes, due to the Bx payment.

200 *See* discussion *supra* Section III.C.a.ii.2 (discussing *IES* and *Compaq*'s application of *Old Colony* to a classic withholding tax fact pattern).

201 Old Colony, 279 U.S. 716, 729 (1929).

counterparty's payment, rather than being economically enriched by higher payments).

As an example of the general approach, assume that a U.S. taxpayer owed $100 of Belgian tax, and its counterparty paid the tax for it (with the counterparty's funds, not by acting as a withholding agent and using the U.S. taxpayer's funds). In that case, the U.S. taxpayer would have a cost of $100 (the foreign taxes that it owed), offset (for purposes of the economic substance analysis) by $100 of income (from the counterparty's paying the taxpayer's obligation out of the counterparty's funds), yielding a net cost of zero. In other words, treating the foreign taxes as a cost and the other party's payment (with its own funds) as income reaches the correct economic result for purposes of the economic substance test, without double counting either amount.[202]

In the example above, if the $100 taxes are U.S. income taxes rather than Belgian taxes, the taxpayer has $100 of income and no offsetting reduction for the income taxes (because U.S. federal income taxes are not treated as a cost in the economic substance calculation). But if the taxes are state taxes, the result is the same as for the Belgian taxes: income of $100 (because of the counterparty's payment of the taxpayer's obligation), and a cost of $100 (state taxes owed by the taxpayer), netting to zero for the economic substance calculation.[203] The same profit result is obtained if the taxpayer claims U.S. tax deductions rather than credits for its foreign taxes. That is appropriate, because the computation of profit for the economic substance test should not depend on the amount of the U.S. tax benefit, given that the relevant amount is pre-*U.S.*-tax profit.

Conceivably, one could try a rule that foreign taxes are a cost except to the extent that the taxpayer proves, to the satisfaction of the Secretary of the Treasury, that the taxpayer does not bear the economic burden of the taxes and that such lack of economic burden is not otherwise sufficiently taken into account under the profit computation (*e.g.*, by means of offsetting the cost against income created by another party paying the tax). But such a rule would be inadvisable because failing to treat foreign taxes as a cost, while treating payment or reimbursement of such foreign taxes as income (under *Old Colony* or basic income tax principles, respectively), creates a distortion.

Using different numbers to illustrate the potential for duplicate counting of income (unless 100% of the foreign taxes are treated as a cost): assume that the taxpayer has a $100 expense (for foreign taxes, rent, or services) and taxpayer's tenant reimburses the taxpayer for $60 of the expense. If the full $100 is not treated as a cost in the profit computation,

---

[202] There could also be partial payment or partial reimbursement of foreign taxes by the counterparty.

[203] *See* Old Colony, 279 U.S. 716, 729 (1929); *see also* 26 U.S.C. § 164(a) (2016) (providing a deduction for state and foreign taxes).

then the taxpayer has $40 of cost (just the portion of the $100 that was not reimbursed by the tenant) plus $60 of income (because of the reimbursement), for a net profit of $20. That is not an accurate measurement of the economic impact, which is instead that the taxpayer has a net $40 expense ($100 less $60 borne by the tenant). Treating the reimbursement as income, and also limiting the expense to the unreimbursed portion, in effect counts the reimbursement twice: once to reduce the amount of the cost, and again as an affirmative amount of income.

In a simplified example based on the STARS cases, for every $100 of income from the trust's assets, treating the foreign taxes as a cost only to the extent of the U.S. bank's (and its subsidiary's) burden for such taxes results in treating the U.S. bank as having an approximately zero net result (cost of only the approximately $11 of foreign taxes for which the U.S. bank and its related parties bore the economic burden, offset by a Bx payment of approximately $11). The economic effect on the U.S. bank is more accurately depicted as a cost of $22, offset by a Bx payment of approximately $11, for net loss of approximately $11. The net loss is a more realistic depiction of the economics because the U.S. bank (through its subsidiary, the trustee) is out-of-pocket $22 of U.K. tax, and receives an offsetting payment for only around half of that amount, not the full amount. The Bx payment did not completely make the U.S. bank whole for the U.K. tax, and therefore computing a net result of zero (or close to it) is not reflective of the economic impact (before U.S. tax effects are considered). It is possible, however, that taxpayers in some future case will disregard the double-counting effect and argue that only a portion of their foreign tax (corresponding to their economic burden after the counterparty's reimbursements and other contractual payments) should be treated as a cost, in situations where such treatment could lead to a computation of positive net profit for economic substance purposes.

As discussed above, part of the reason for the government's dislike of the STARS transactions is that Barclays is sharing the economic burden of the trust's U.K. taxes. But, ironically, after focusing on the economic burden for the foreign taxes, the STARS courts do not discuss whether the U.S. bank's lack of full economic burden should prevent treatment of a proportionate amount of the foreign taxes as a cost.

The STARS taxpayers could not have prevailed by making this argument, in any event, because almost all of them lacked profit even if the portion of the foreign taxes treated as a cost was limited to the excess of foreign tax over the Bx payment. Such excess was greater than or equal to the Bx payment, yielding zero or a net loss, for every U.S. bank except Salem. For Salem, the Bx payment was approximately 51% of the trust's taxes. If one treated as a cost only the portion of the foreign taxes for which that U.S.

bank bore the economic burden (49%) and offset that cost with the Bx payment (51% of the trust's taxes), the result is profit of approximately 44 cents for each $22 of foreign tax credit (even before taking into account any other costs, such as transaction costs). Under case law that finds de minimis profit (as compared to tax benefits) to be insufficient to meet the objective prong,[204] such a small pre-*U.S.*-tax profit is very unlikely to allow a taxpayer to meet the objective analysis.

In summary, treatment of foreign taxes as a cost is a harder issue, conceptually, if the taxpayer does not bear the economic burden of the foreign taxes (or bears only part of such burden). But treating the other party's payment or reimbursement of the taxpayer's taxes (with the other party's own funds) as income has the desired effect (after netting for purposes of the economic substance analysis) of offsetting foreign tax as a cost to the extent the taxpayer does not bear the economic burden of such taxes. In computing profit for purposes of the economic substance doctrine, foreign taxes should be treated as a cost, and any other party's payments that constitute income to the taxpayer should functionally net against that cost to yield a sufficiently accurate approximation of the net economic burden that the taxpayer bears for such foreign tax.

2. Are the Bx Payments Income?

The Bx payment, in each STARS fact pattern, was paid by Barclays to the U.S. bank (or its U.S. subsidiary), and was computed as a set percentage (varying with each case, but always near 50%) of the trust's U.K. taxes. The contracts between the parties provided that if Barclays could not obtain its expected U.K. tax credits for the trust's taxes, the U.S. bank would owe Barclays an indemnification payment of approximately half of the trust's taxes (*i.e.*, approximately the amount of the Bx payment).[205] In practice, then, the U.S. banks' receipt of the Bx payment depended on Barclays' obtaining U.K. tax benefits.

The parties described the Bx payment, in litigation, as payment by Barclays to the U.S. bank for "services rendered": for the U.S. bank's placing its assets in the trust, naming a U.K. trustee, and participating in the circular cash flows of the STARS transaction, all so that Barclays could claim U.K. tax benefits.[206] In that sense, one could see the U.S. bank as an accommodation party, receiving a fee for participating (in form only, without

---

[204] *See infra* note 240.

[205] *See, e.g.*, Salem II, 786 F.3d 932, 939 (Fed. Cir. 2015).

[206] *See, e.g.*, Wells Fargo I, 143 F. Supp. 3d 827, 835 (D. MN. 2015) ("[The U.S. bank] contends, [that] the Bx payment was money paid by one private party (Barclays) to another private party (Wells Fargo) as compensation for services rendered (Wells Fargo's voluntary exposure of its assets to U.K. taxation)."); *Salem II*, 786 F.3d at 945 ("The payments were made in consideration of BB&T's services rendered under the STARS transaction, including BB&T's acts of creating the STARS Trust and subjecting its U.S.-based assets to U.K. taxation.").

real consequences to itself) in a transaction that was shaped for the other party's benefit. From the U.S. government's point of view, this fee to the U.S. bank functionally reimbursed the bank for approximately half of the trust's U.K. tax, enabling the U.S. bank to bear approximately half of the costs of the foreign taxes that it claimed as foreign tax credits (*i.e.*, the Groupon effect).[207]

The government argued that the Bx payment was not income (and did not increase profit), for purposes of the economic substance analysis, because such "payment is in substance a rebate of the U.K. taxes that [the U.S. bank] paid on behalf of the Trust."[208] The government contended that although the Bx payment was made from Barclays to the U.S. bank, it was effectively a payment from the *U.K. government* to the U.S. bank, partly because the funds for the Bx payment were derived from Barclays' U.K. tax credit for the trust's taxes.[209] The Bx payment was therefore, the government argued, in substance a "tax item" and not income. The government did not explain how its argument that a U.K. tax rebate is not income can be consistent with its other argument that a U.K. tax obligation is a cost (in other words, one U.K. tax item was disregarded and another was regarded, for purposes of the profit computation).

There is not really any viable argument that the Bx payment is a U.S. tax effect, and therefore excluded from the "profit" computation. The only potentially applicable authority appears to be the "subsidy" rule of the Code and the Treasury Regulations.[210] That rule, in brief, makes a foreign tax non-creditable to the extent that the taxpayer, a counterparty, or certain other persons receive a benefit from the foreign government that is computed by reference to either the amount of the foreign tax or the amount of the foreign tax base.[211] The subsidy rule is thus not directly applicable to the question of whether an amount (such as the Bx payment) constitutes gross income, but instead relates to whether a foreign tax is treated as an amount of tax paid (and

[207] *See, e.g.*, Salem I, 112 Fed. Cl. 543, 586 (2013) ("The transaction became immensely profitable to BB&T when it claimed U.S. foreign tax credits for a U.K. tax cost *that it had not in substance paid.*" (emphasis added)).

[208] *Salem II*, 786 F.3d at 940–41. Note that the U.K. trustee technically paid the U.K. taxes on the trust's income, using funds set aside by the trust. However, the STARS opinions tend to refer to the U.S. bank as paying such taxes (apparently as a kind of shorthand, on the theory that because the trustee was a 100% owned subsidiary of the U.S. bank, and the trust was controlled by the bank, the U.S. bank ultimately bore the cost of such U.K. taxes). *See, e.g.*, *id.*; BNY Mellon II, 801 F.3d 104, 110 (2d Cir. 2015).

[209] *See, e.g.*, Santander I, 977 F. Supp. 2d 46, 51 (D. MA. 2013); Wells Fargo, 143 F. Supp. 3d 827, 839 (D. MN. 2015).

[210] *See* 26 U.S.C. § 901(i); Treas. Reg. § 1.901-2(e)(3). However, the *Wells Fargo* court argues that the lack of any applicable authority (to support the argument that the Bx payment is not income because it is functionally a tax rebate) is not dispositive, because there is a first time for every argument. *See Wells Fargo I*, 143 F. Supp. 3d at 838.

[211] *See id.* The "refund rule" of the regulations similarly has the effect of making foreign taxes non-creditable if they are reasonably certain to be refunded or rebated (or returned by certain other means) to the taxpayer by the foreign government. *See id.* §1.901-2(e)(2).

thus is potentially creditable).[212] The government conceded, in the STARS cases, that the subsidy rule did not literally apply to the Bx payment.[213] But the government argued that, even without the literal application of the subsidy rule, "the Barclays payment was 'in substance' a rebate from the U.K." and was thus in the nature of a tax benefit and should not be treated as income.[214]

However, as the STARS taxpayers and various STARS courts have correctly pointed out, the Bx payment is not a refund from the U.K. government but instead a payment from Barclays (the counterparty). So the payment is not technically a tax rebate, and does not literally trigger the subsidy rules (which, in any event, do not address the definition of "income" or "profit"). Nothing in the existing statutory or regulatory iterations of the subsidy rule or the refund rule[215] goes beyond the concept of a benefit that is provided (directly or indirectly) by the foreign government.[216] The *Santander I* opinion similarly cited authority to the effect that amounts paid from private parties are not treated as if they were tax benefits or rebates paid by a government.[217]

There does not seem to be any authority that says that a payment is not income solely because it is computed by reference to the amount of foreign tax.[218] Nor does the Bx payment fall within the rule that U.S. tax effects are disregarded (for purposes of determining profit under the economic substance test), because the Bx payment is not a U.S. Federal income tax item (*i.e.*, it is not a tax benefit provided by or tax cost imposed by the U.S. government). The default rule for federal income tax purposes, of course, is that income includes "all income from whatever source derived . . . ."[219]

The government did not articulate any other persuasive avenue of

---

[212] *Amoco*, for example, employs a narrow reading of the subsidy and refund rules. *See* Amoco, 138 F.3d 1139, 1145, 1149 (7th Cir. 1998).

[213] *See, e.g.*, *Santander I*, 977 F. Supp. 2d at 49–50.

[214] *Id.* at 51.

[215] *See* 26 U.S.C. § 901(i); Treas. Reg. § 1.901-2(e)(2) (providing the refund rule); *id.* § 1.901-2(e)(3) (providing the subsidy rule).

[216] One could argue about instances in which one part of a foreign government (*e.g.*, the taxing authority) imposes tax, and a different part of the same government (*e.g.*, the governmental housing authority, customs agency, or environmental regulatory agency) provides a benefit. But the distinction between a foreign taxing authority and a private party is more extreme.

[217] *See Santander I*, 977 F. Supp. 2d at 51 (citing Doyon Ltd. v. United States, 37 Fed. Cl. 10, 22–24 (1996); I.R.S. Priv. Ltr. Rul. 200951024 (Dec. 18, 2009); I.R.S. Priv. Ltr. Rul. 200348002 (Nov. 28, 2003); I.R.S. Priv. Ltr. Rul. 8742010 (July 10, 1987)).

[218] *Salem II* states:

> That the Bx payments were calculated by reference to BB&T's [trust's] U.K. taxes is insufficient to convince us otherwise. Contracting parties are free to structure their transactions based on any payment formula, including calculating a payment by reference to a party's tax liability . . . . We are aware of no authority . . . in which courts have treated private payments as tax effects rather than income simply because the amount of the payments was calculated based on a tax-based formula.

Salem II, 786 F.3d 932, 946 (Fed. Cir. 2015).

[219] 26 U.S.C. § 61 (2016). As noted above, however, the profit computation for economic substance test purposes is not necessarily identical to the taxpayer's annual calculation of taxable income for federal income tax purposes.

attack to show that the Bx payment was not income. In effect, the Bx payment represented Barclays' bearing part of the economic burden of the trust's U.K. taxes, which were paid by the U.S. bank's U.K. subsidiary (the trustee). But no rule prevents "income" merely because a counterparty's payment represents its reimbursement of part of the taxpayer's costs.[220] In addition, "morally questionable" activity does not prevent income. Therefore, even if the U.S. taxpayers should not be facilitating Barclays' U.K. tax play by participating in a circular flow and a non-meaningful trust arrangement, that does not preclude income.[221] Typically, U.S. tax law treats an accommodation party's fees as income regardless of whether the government approves of the transaction such party is facilitating, and even if the underlying transaction is an economic sham for the main participants.[222]

The courts were divided on the treatment of the Bx payment. Some of the STARS courts concluded that the Bx payment was income to the U.S. bank because it was not properly treated as a tax rebate. For example, *Santander I* and *Salem II* cited the concept that another party's payment of a taxpayer's obligation is generally income to the taxpayer, under *Old Colony*.[223] The *Santander I* court also cited the regulatory rule that a taxpayer's entitlement to a foreign tax credit is not affected by whether the tax is paid by another person, for example by a counterparty.[224] However, neither the *Old Colony* principle nor such regulatory rule technically applies to the Bx payment, because Barclays did not pay the U.S. bank's tax to the U.K. government, but instead paid to the U.S. bank an amount computed as a percentage of that U.K. tax. Arguing that *Old Colony* or such regulation applies would require finding that the Bx payment was in effect a payment from Barclays to the U.K. government. In any event, neither *Old Colony* nor such regulation is necessary in order to find that the Bx payment is income—general income tax principles, including the basic rule that income includes "all income from whatever source derived,"[225] will suffice.

In contrast, *BNY Mellon I*, *BNY Mellon II*, *Salem I*, and *Wells Fargo* II held that the Bx payment was not income. *Salem I* stated that the Bx payment was "not profit," and that instead "[t]he Bx payment simply reimbursed BB&T for one-half of its out-of-pocket U.K. tax costs on the transaction."[226] It found that "[t]he economic nature of the Bx payments

---

[220] Generally, a third party's payment of the taxpayer's obligation is income to the taxpayer. *See* Old Colony, 279 U.S. 716, 729 (1929). However, that rule is not technically relevant in the STARS cases, where Barclays paid the Bx payment to the U.S. bank, rather than paying the U.K. for the Trust's taxes. *See* discussion *supra* Section III.C.a.ii.2.

[221] *Alessandra v. Commissioner*, for example, demonstrates that even amounts earned by facilitating a tax shelter are included in income for federal income tax purposes. 68 T.C.M. (CCH) 1288 (1994), *aff'd without pub'd op.*, 111 F.3d 137 (9th Cir. 1997).

[222] *See, e.g.*, *id.*

[223] *See* Old Colony, 279 U.S. 716, 729 (1929).

[224] *See* Santander I, 977 F.Supp. 2d 46, 53 (citing Treas. Reg. § 1.901-2(f)(2)).

[225] *See* 26 U.S.C. § 61 (2016).

[226] *See* Salem I, 112 Fed. Cl. 543, 586 (2013).

simply is a tax effect, and in particular a U.S. tax effect . . . ."[227] *Salem I* was reversed on this issue on appeal.[228] *Santander III*, which reversed *Santander I* on the general economic substance issue, found it unnecessary to address the treatment of the Bx payment.[229]

The *Wells Fargo* jury concluded that the Bx payment was "a tax benefit" rather than "revenue." The *Wells Fargo* judge agreed that it was "not an item of pre-tax revenue" because it was "simply the means by which the parties split the tax benefits that STARS generated out of economically meaningless activity."[230] The court in *Wells Fargo* had previously denied the taxpayer's motion for summary judgment on the question of whether the Bx payment was income for this purpose, and instead left the issue for the jury.[231] The *Wells Fargo* judge stated, however, that he was inclined to agree with the government on this issue.[232] He was troubled by the idea that payment from a private party to perform meaningless activity (subjecting the assets to U.K. tax and engaging in circular cash flows) can be income.[233] He also thought that a jury might find that the funds for the Bx payment functionally came from the U.K. Treasury (presumably by means of the U.K. tax benefits that Barclays derived), making it a non-income "tax effect." This theory does not address why such an item would be a U.S. rather than a U.K. tax effect, but the difference might not matter under certain interpretations of the Eighth Circuit's approach to foreign tax items in *IES*.[234]

Although some courts phrased their conclusion in terms of whether or not the Bx payment was "profit,"[235] they seem to have meant that the payment was or was not "income" for economic substance test purposes. Reimbursement for costs (here, for the U.K. tax costs) may be income even if it does not result in net *profit* once costs are taken into account—*i.e.*, income and profit are not the same concept. Profit means gross income less costs and

---

[227] *Id.* It is not clear how the Bx payment could be a U.S. tax effect (rather than a U.K. tax effect, if one views it as effectively part of the U.K. tax credit that Barclays claimed for the trust's taxes). One could logically argue, though, that *if* the Bx payment was a U.K. tax effect (in substance, because it derived from Barclay's U.K. tax benefits), and *if* U.S. and foreign tax effects are treated identically to each other (which, as argued above, is the wrong answer), then a Bx payment should be treated the same way (in the economic substance analysis) as if it were a U.S. tax effect. In that case, the Bx payment is not income.

[228] *See* Salem II, 786 F.3d 932 (Fed. Cir. 2015).

[229] Because *Santander III* held that the trust's U.K. taxes were a cost for purposes of computing profit, the trust transaction had no net profit, regardless of whether or not the Bx payment was treated as income. Mathematically, that is the result because the U.K. taxes were approximately twice the size of the Bx payment.

[230] *See* Wells Fargo II, No. 09-CV-2764, 2017 U.S. Dist. LEXIS 80401, 2017-1 U.S. Tax Cas. (CCH) P50,235 (D. MN. May 24, 2017) at 3, n. 1.

[231] *See* Wells Fargo I, 143 F. Supp. 3d 827, 839, 854 (D. MN. 2015).

[232] *See id.* at 835, 841.

[233] The *Wells Fargo I* court opinion raises an interesting question about why the Bx payment should be considered income (and help reach "profit") if paid by another party, when the same transaction (placement of assets in a trust, and circular cash flows) might be disregarded if the taxpayer acted on its own without a counterparty. *Id.* at 836. *Cf. infra* text accompanying note 266 (discussing business purpose of accommodation parties who earn fees, but whose fees are less than their costs).

[234] IES, 253 F.3d 350 (8th Cir. 2001).

[235] *See, e.g.*, BNY Mellon I, 140 T.C. 15, 36 (2013).

expenses, while income means gross income before reduction by expenses. Because there was a controversial issue about whether the U.K. taxes were a cost or not, and because the U.K. taxes were approximately twice the amount of the Bx payment, it was possible for the Bx payment to constitute gross *income* without giving the U.S. bank a net *profit* (if foreign taxes were a cost in the profit computation).[236] In other words, the question of profit was still unresolved (and could go either way) whether or not the Bx payment was income. Logically, the government needed to win *either* the argument that the Bx payment was not income, or the argument that foreign taxes were a cost, in order to show that the STARS transaction had no realistic possibility of profit. Winning both arguments was not necessary and losing one of the two arguments was not fatal for the government. The taxpayers, in contrast, needed to win both the argument that foreign taxes are not a cost and also the argument that the Bx payment is income, in order to meet the objective prong.

On a related note, taxpayers argued that because the government conceded that the Bx payment did not technically fall within the subsidy regulation, and because the regulation defines a subsidy based on "[s]ubstance and not form,"[237] the government had indirectly conceded that the Bx payment had substance and that the STARS transactions therefore also met all requirements of the economic substance doctrine.[238] The courts generally rejected this argument, holding that the economic substance doctrine can apply even if a code or regulatory provision contains its own internal substance requirement.[239]

In summary, the Bx payments are better treated as income for purposes of the profit determination under the economic substance doctrine. No rule provides an avenue for finding that such payments are not income, unless and until the trust transaction is found to lack economic substance (in which case no U.S. tax effects, including income from the Bx payment, result from such transaction). The circuit courts are currently split on this issue, with *Salem II* holding that the Bx payment was income for economic substance purposes, and *BNY Mellon II* holding to the contrary, while *Santander III* does not address the issue. This leaves open the issue of whether an amount that is traceable to a counterparty's foreign tax benefits or to the reimbursement of the U.S. person's foreign tax costs is treated as income (or instead as a tax effect) for the U.S. taxpayer, for purposes of the economic substance analysis.

---

[236] *See, e.g., id.* at 43 n.15 ("We note that, regardless of how the [Bx payment] is characterized, the benefit of the spread [the Bx payment] was more than offset by the additional transaction costs [including foreign taxes] that BNY incurred to obtain the spread.").

[237] *See* Treas. Reg. §1.901-2(e)(3)(ii).

[238] *See, e.g., Wells Fargo I*, 143 F. Supp. 3d at 840; *Salem II*, 786 F.3d at 941-42.

[239] *See id.* at 941-42.

3. Amount of Profit: How Much is Sufficient?

Even after the method of computing profit has been decided and the amount of profit has been determined, there remains an issue of whether the amount of profit is sufficient. Several economic substance cases have stated that in order to pass the objective prong of the economic substance doctrine, the taxpayer's profit must be more than de minimis in relation to the amount of the expected tax benefits.[240] Therefore, even if a taxpayer has profit for purposes of the economic substance test, the amount of such profit in relation to the expected U.S. tax benefits is still relevant.

Few courts have addressed an economic substance case in which, as in the STARS cases, there is profit (if the Bx payments are income but the foreign taxes are not a cost), which is far less than tax benefits but not "insubstantial" or "de minimis" in relation to such tax benefits. The STARS cases bring to mind the question, then, of whether profit can be more than insubstantial in relation to expected tax benefits, but still not sufficient.[241] In the STARS cases, taxpayers reasonably expected a loss (if foreign taxes are a cost). If foreign taxes are *not* treated as a cost, then profit (roughly equal to the amount of the Bx payment) was approximately half of the U.S. taxpayer's expected foreign tax credits, *i.e.*, the ratio of profit to expected U.S. tax benefits was roughly 1:2.[242] Although terms like "more than de minimis" and "substantial" (standards used in the case law[243] and section 7701(o),[244] respectively) are not defined,[245] it seems quite clear that a 1:2 ratio shows profit that meets these standards.

[240] *See* Sheldon v. Comm'r, 94 T.C. 738, 768 (1990) (explaining that profit that is "de minimis" is not enough, and stating that the profit was "infinitesimally nominal and vastly insignificant when considered in comparison with the claimed deductions"); Knetsch v. United States, 364 U.S. 361, 366 (1960) (finding the expected profit was "a relative pittance" and therefore insufficient); WFC Holdings Corp. v. United States, 728 F.3d 736, 746 (8th Cir. 2013) ("Modest profits [compared] to substantial tax benefits are insufficient . . . ." (citation omitted)); *see also* Salem II, 786 F.3d 932, 947 (Fed. Cir. 2015) ("[N]on-tax return [that] is grossly disproportionate to the tax benefits [is not enough] . . . ."); *cf.* ACM P'ship v. Comm'r, 157 F.3d 231, 258 (3d Cir. 1998) (regarding business purpose, "nominal, incidental pre-tax profit . . . would not support a finding that the transaction was designed to serve a non-tax profit motive" (citation omitted)); I.R.S. Notice 98-5, 1998-1 C.B. 334 (withdrawn) (predicting the issuance of regulations that would provide that reasonably expected profit must be more than insubstantial in relation to expected foreign tax credits, in order for such credits to be respected); 26 U.S.C. § 7701(o)(2)(A) (providing that profit must be at least substantial in relation to expected tax benefits, in order for profit to be taken into account under the economic substance test).

[241] *But see* Joseph Bankman, *Articles and Essays: The Economic Substance Doctrine*, 74 S. CAL. L. REV. 5, 26 (2000) (raising the converse question of whether profit should be sufficient if it is objectively substantial, viewed in isolation, even if it is much smaller than expected U.S. tax benefits).

[242] The exact ratios vary slightly from case to case depending on the percentage that the Bx payment bore to the U.K. taxes imposed on the trust in each case. But, in all of the STARS cases, the Bx payment is close to or equal to 50% of such taxes.

[243] *See supra* note 240.

[244] *See* 26 U.S.C. § 7701(o)(2)(A) (2016).

[245] Some practitioners have looked to the profit-to-foreign tax credit ratios in the examples of I.R.S. Notice 98-5 for guidance, even though that notice has been withdrawn. *See, e.g.*, Pritired 1, LLC v. United States, 816 F. Supp. 2d 693, 701, 711, 729 (S.D. Iowa 2011); *see also* I.R.S. Notice 98-5, 1998-1 C.B. 334 (withdrawn).

Taxpayers will likely argue that the cases (such as *Sheldon*) create a negative inference that anything more than de minimis profit (compared to expected tax benefits) is enough.[246] But these cases did not need to address the finer points of how much profit was sufficient: they analyzed fact patterns with only miniscule amounts of profit. For years to which it applies, section 7701(o) states that profit will not be taken into account for purposes of the objective or subjective prong unless the profit is "substantial" compared to reasonably expected tax benefits.[247] The section 7701(o) test of "substantial" appears to be derived from former Notice 98-5,[248] although the House and Joint Committee reports do not so state.[249] Neither the notice nor section 7701(o) applies to the years at issue in the STARS cases.

For the STARS cases, a 1:2 ratio of expected profit to expected U.S. benefits (if the Bx payment is income but foreign taxes are not a cost) is not insubstantial, but it is disproportionate. Should the standard for the amount of profit be higher than "substantial," before section 7701(o) applies? Should the required minimum amount of profit vary based on the type of tax benefit being claimed, on the theory that the intent of each statute should be taken into account in reaching this standard? Note that the intent of the particular statute is taken into account in determining if the economic substance doctrine applies at all.[250]

The appellate opinions in *Compaq* and *IES* did not address this issue of how much profit was sufficient. Presumably, the profit-to-tax benefit ratios that those cases describe, based on those circuit's interpretations of the facts, can be cited as examples of adequate profit amounts. Nor does the *Santander* lower court, the only STARS opinion to find that the U.S. bank had profit from the trust transaction, explicitly address the issue of how much profit is sufficient. (Apparently, however, it thought that a 1:2 ratio of profit to U.S. tax benefits was adequate.) The remaining STARS opinions, and the lower court opinions in *Compaq* and *IES*, had no need to discuss how much profit was adequate because they found that profit from the trust was zero.[251]

For transactions before section 7701(o)'s effective date, these remain

---

246 *See supra* note 240.

247 *See* 26 U.S.C. § 7701(o)(2)(A).

248 *See* I.R.S. Notice 98-5, 1998-1 C.B. 334 (withdrawn by Notice 2004-19) (predicting that "these [future] regulations will disallow foreign tax credits in an arrangement such as those described in Part II above from which the reasonably expected economic profit is *insubstantial* compared to the value of the foreign tax credits expected to be obtained as a result of the arrangement." Emphasis added).

249 *See* House Report, *supra* note 129, at 298 (describing the profit ratio test); Joint Committee Report, *supra* note 129, at 155 (using similar language, with a different footnote, to describe the ratio test).

250 *See, e.g.*, Horn v. Comm'r, 968 F.2d 1229, 1231 (D.C. Cir. 1992). Note that section 7701(o) applies only if the economic substance doctrine is "relevant," and the determination of relevance is left to the courts. *See* 26 U.S.C. § 7701(o)(1), (5)(C).

251 Most of the STARS opinions did not give an extensive analysis of the loan's profit potential, although all of them (except *BNY Mellon I*, before reconsideration of the interest deduction by the Tax Court, and *Santander III*, which did not consider the loan) found that the loan met the objective prong. *See* discussion *infra*.

open questions. After that effective date, section 7701(o) mandates that profit must be "substantial in relation to . . . expected net tax benefits" before such profit can be taken into account for purposes of the objective and subjective prongs.

The amount of the acceptable profit-to-tax-benefit ratio can be expected to be very, very relevant in the future. Among other things, one can expect discussion of what "substantial" (the minimum ratio required by section 7701(o)) means in mathematical terms. (For example, is 1:20 acceptable? Is 1:50 too low, but 1:10 is sufficient?). Taxpayers might continue looking to the numeric examples in Notice 98-5, which has long been withdrawn but which used the term "insubstantial"[252] (similar to the "substantial" terminology in section 7701(o)), as well as *Compaq* and *IES*. One can also expect spirited discussion of whether section 7701(o)'s standard of "substantial" profit (in relation to tax benefits) prevents the courts or the IRS from setting out a more stringent standard—*i.e.*, whether section 7701(o) sets forth a minimum (allowing courts or administrative guidance to require more than "substantial" profit) or establishes the exclusive standard (*i.e.*, "substantial" is the only acceptable test for whether the amount of profit can be taken into account under the two prongs).

This issue is raised not only by the trust structure of the STARS transactions but also by the loan, which cost the U.S. banks a higher-than-market interest rate (a higher rate than the U.S. banks could have found elsewhere), if the Bx payment is treated as part of the trust structure rather than as part of the loan. (If the Bx payment were instead treated as relating to the loan, the interest rate on the loan would be viewed as lower.)

The STARS appellate courts in *Salem II* and *BNY Mellon II* both decided that the loan transaction passed the objective portion of the economic profit test, despite its higher-than-market interest rate and the lack of any detailed showing by the taxpayers to prove that investments made with the borrowed funds yielded a higher return than the interest owed.[253] These opinions appear to rely on the fact that the loans changed the economic circumstances of the taxpayers (by giving them access to a large amount of cash). Change in economic circumstances is an alternative to the profit computation, as a means of meeting the objective prong, in many circuits and under section 7701(o).[254] This alternative may take some of the pressure off of the determination of how much profit is "substantial" after section 7701(o), and how much is sufficient before section 7701(o) applies.

[252] *See* I.R.S. Notice 98-5, 1998-1 C.B. 334 (withdrawn by Notice 2004-19).
[253] The *Santander III* court did not need to consider the loan's economic substance, because the government did not pursue that issue on appeal (focusing instead on the trust transaction). *See* Santander III, 844 F.3d 15 (1st Cir. 2016).
[254] *See* section 7701(o)(1)(A); *see also, e.g.*, *Salem II*, 786 F.3d at 950.

D. *Business Purpose: What is Business Purpose, How Much is Required, and What is Likely to Happen to the Business Purpose Analysis in the Future?*

1. Business Purpose in General

The STARS cases also addressed the issue of whether the STARS transactions have sufficient business purpose to meet the economic substance test. Business purpose is the second half of the economic substance test, and is also known as the "subjective prong" (in contrast to the objective prong, which emphasizes an examination of expected profit or change in economic circumstances).[255]

The government could have won the STARS cases on business purpose alone, even if it lost both of its arguments about economic profit (character of the Bx payment as income and treatment of foreign taxes as a cost), depending on the relevant circuit's pre-section-7701(o) formulation of the economic substance doctrine. Under the conjunctive test, the government can theoretically win an economic substance challenge by winning the subjective prong argument, even if it loses on the objective prong. This is where the description of the doctrine (as a conjunctive, disjunctive, or flexible test) can make a difference: the disjunctive test (under pre-section-7701(o) law) allows the taxpayer to win if it succeeds on either the objective or subjective prong, while the conjunctive test and (section 7701(o)) require the taxpayer to win both prongs in order to have its tax benefit respected. The results of the flexible test could vary. Section 7701(o)'s enactment thus may make a difference in some courts for future cases. *Santander I*, for example, said that it was unnecessary to examine the subjective prong if the taxpayer wins the objective analysis, and *Santander III* was generally reluctant to examine subjective motives, but courts will not be able to take that approach for transactions to which section 7701(o)'s effective date applies (*i.e.*, transactions after March 30, 2010).

Business purpose is likely to increase in importance in the future, compared to its current role in the economic substance analysis. It presents the government and the courts with an additional weapon, if profit is substantial in relation to expected U.S. tax benefits. In that case, the objective part of the economic substance test is likely met, under the case law and under section 7701(o)'s formulation. This is especially true if section 7701(o)'s requirement that profit be substantial in relation to tax benefits is read as preventing the courts from requiring more profit (*i.e.*, profit that is more than substantial in relation to tax benefits). If the taxpayer thus meets the profit

[255] Some circuits describe their version of the economic substance test as not being a rigid two prong test, but almost every description includes objective profit potential and subjective business purpose. *See, e.g.*, BNY Mellon II, 801 F.3d 104, 115 (2d Cir. 2015); ACM P'ship v. Comm'r, 157 F.3d 231, 247 (3d Cir. 1998).

test, the business purpose test becomes an alternative avenue for a court or the IRS to disallow tax benefits under the economic substance doctrine. The business purpose analysis can only perform this function if it is different from the profit analysis (and not necessarily satisfied every time the objective prong is satisfied). The business purpose test, if it means something different than the objective prong, also avoids (or places less emphasis on) the controversial issue of whether foreign taxes are a cost. All of these considerations place more weight on determining what exactly business purpose means, which is not answered in much detail under the case law.

2. What Does Business Purpose Mean?

Business purpose is generally described as the taxpayer's subjective intent to achieve non-tax business objectives (as opposed to the taxpayer's subjective focus on tax benefits), but the economic substance case law lacks a clear, detailed definition of how to determine business purpose and how much business purpose is sufficient. Nor do section 7701(o) or its House or Joint Committee reports give a detailed definition of what the business purpose prong means.[256] The business purpose analysis tends to (at least partially) overlap the profit analysis.[257] Courts have also commonly examined whether taxpayers engaged in due diligence and whether they otherwise showed the care that a reasonable businessperson would use in engaging in real business transactions.[258] For example, courts have examined whether (and for how long) taxpayers met with tax shelter promoters to discuss a transaction before investing, and whether taxpayers reviewed detailed documentation regarding the transaction before committing their funds. A small amount of such due diligence has sometimes been sufficient.[259]

In many court opinions, the business purpose analysis appears to be less important to the economic substance conclusion than the objective prong, and courts seldom reach different conclusions for the two prongs.[260] Perhaps

[256] *See* 26 U.S.C. § 7701(o) (2016); House Report, *supra* note 129, at 297-98 and n. 135; Joint Committee Report, *supra* note 129, at 154 and n. 354.

[257] *See, e.g.*, Wells Fargo & Co. v. United States, 2014 U.S. Dist. LEXIS 99111, at *75–76 (D. MN. July 22, 2014) ("The two prongs of the sham transaction test are thus often mentioned, but the difference between them is almost never fully explained.").

[258] *See, e.g.*, Rice's Toyota, 752 F.2d 89, 92-93 (4th Cir. 1985).

[259] *See Compaq*, 277 F.3d at 787 n.9; IES, 253 F.3d 350, 355 (8th Cir. 2001).

[260] *See* Wells Fargo & Co. v. United States, 2014 U.S. Dist. LEXIS 99111, at *75–76 (D. MN. July 22, 2014) ("Neither party cites a case in which a court finds a business purpose, but no economic substance or economic substance, but no business purpose."). The *Wells Fargo* jury's conclusion regarding the STARS loan (which was held to have profit potential but to lack sufficient business purpose) was an exception. *See* Wells Fargo II, No. 09-CV-2764, 2017 U.S. Dist. LEXIS 80401, 2017-1 U.S. Tax Cas. (CCH) P50,235 (D. MN. May 24, 2017) at 3, n.1. The *Cherin* court also implied that the taxpayer might have been able to win the business purpose prong despite losing the objective analysis. However, the court did not find the evidence strong enough to "mandate" a finding of sufficient non-tax business purpose. Business purpose was moot in any event because the court applied a conjunctive version of the economic substance test (stating that business purpose was not enough, alone, to show that a transaction should be respected), and the taxpayer lost on the objective prong. *See* Cherin, 89 T.C. 986, 992-93 (1987).

as a result, the precise definition of the required subjective business purpose has been somewhat unclear.

However, the profit analysis and business purpose prongs should not be identical to each other, because that would make the business purpose prong superfluous and meaningless.[261] That conclusion is reinforced, under section 7701(o), by principles of statutory interpretation. Section 7701(o) makes the two prongs equal to each other by requiring that both prongs must be satisfied in order for a transaction to have economic substance. If business purpose were identical to the objective prong, it would violate the principle that statutory language is presumed not to be moot or superfluous, whenever possible. It could become less rare, in the future, for the two prongs to reach different results, if section 7701(o) requires the business purpose prong to be defined differently than the objective prong

If business purpose is not identical to the profit analysis, what does it mean? As discussed above, the courts have also looked to due diligence, shown largely by the taxpayer's efforts to research and discuss the transaction, and have sometimes considered the upside and downside risk. That leaves open the question of whether anything else should be considered in making this business purpose determination. There may be a push in the future to add some heft and additional detail to the business purpose test.

The STARS cases bring to mind another interesting problem regarding business purpose: if the taxpayer has a positive profit, but less profit than it could have made with a different transaction, what is the impact on the economic substance analysis, especially in the business purpose prong? For example, the STARS taxpayers presumably made money with the borrowed cash (*i.e.*, the courts generally assumed that the U.S. banks invested the borrowed money to earn a return of more than their interest rate), but could have borrowed at less than that interest rate. (This issue relates to the loan from Barclays to the U.S. bank, because the remainder of the STARS structure (the trust) had no profit (except according to the *Santander* lower court's findings, which were overruled by the First Circuit)).

The STARS courts that addressed the issue (other than the *Wells Fargo* jury) all found that the loan included in the STARS transaction, when tested separately from the remainder of the transaction, had sufficient business purpose and met the economic substance test.[262] With respect to the

---

[261] *Cf.* Wells Fargo & Co. v. United States, 2014 U.S. Dist. LEXIS 99111, at *75–76 (D. MN. July 22, 2014) ("One possible construction is that any transaction that passes the economic substance test (based upon reasonable profit expectations) is by definition motivated by a business purpose. In that event, the subjective test would only become relevant if there was no economic substance. If that analysis is appropriate, however, it would be reasonable to expect clear authority to that effect.").

[262] The Tax Court in *BNY Mellon I* initially found to the contrary, but the Tax Court reversed its finding on the loan when it re-heard the issue. *See* Bank of N.Y. Mellon Corp. v. Comm'r, 106 T.C.M. (CCH) 367 (2013). The *Santander III* court did not address the loan. *See* Santander III, 844 F.3d 15 (1st Cir. 2016). The Wells Fargo jury found that the loan had profit potential but not business purpose. *See Wells*

loans, the court opinions appear to focus on whether borrowing had a business purpose, rather than on whether choosing this particular loan over other available loans (which would have had better interest rates) had a business purpose.

The STARS cases leave open the possibility that a taxpayer's rejection of more profitable options can be a factor in determining whether the taxpayer had sufficient business purpose—that courts can ask whether there were ways to make *more* profit, and can take into account that the taxpayer chose less profit and more tax benefits.[263] Given the STARS courts' decisions to respect the loans, this availability of lower cost funding (of more profitable alternatives) does not seem to be a determinative factor (on its own). But that does not mean that it is irrelevant, or that it could not be a final, damning element in other fact patterns. The government could conceivably argue (in other cases) that for the foreign tax credit in particular, the choice of a lower profit alternative in order to obtain foreign tax credits (or to increase foreign tax credits) is contrary to statutory intent and should not be rewarded with U.S. tax benefits. The government could also, in theory, issue guidance interpreting section 7701(o) (using the general regulatory power granted under section 7805), to address the relevance of the taxpayer's rejection of higher profit alternatives in the economic substance analysis.[264]

The STARS cases also bring to mind the issue of whether the business purpose test applies differently when the taxpayer is an accommodation party in a tax arbitrage transaction that may allow a counterparty to take inappropriate advantage of another country's tax system. There is no authority that says that an accommodation party's earning a net profit cannot be a business purpose (*e.g.*, for moral or policy reasons), even if the point of the transaction as a whole is to achieve foreign tax benefits for the

---

Fargo II, No. 09-CV-2764, 2017 U.S. Dist. LEXIS 80401, 2017-1 U.S. Tax Cas. (CCH) P50,235 (D. MN. May 24, 2017) at 3.

[263] *See, e.g.*, Wells Fargo I, 143 F. Supp. 827, 845-46 (D. MN. 2015) (suggesting that the availability of cheaper funding is a factor that the jury can take into account in evaluating whether the STARS transactions had economic substance).

[264] For example, assume that the taxpayer could have rented its building for a net pre-tax profit of 100, but chose to rent the building for a net pre-tax profit of 20, in order to receive tax benefits of 500. One would first ask whether the statute (which grants the tax benefits) intended to encourage such choices. The low income housing credit, for example, arguably is intended to use tax benefits to cause otherwise non-economic investments. In the rent example above, if the statute did not intend to encourage non-economic transactions then one could hypothesize that perhaps the correct policy answer might be to allow 20/100 (1/5) of the tax benefits (the same ratio that the expected profit bears to expected profit from other transactions). But the economic substance doctrine disallows all U.S. tax effects (100%, not a portion) of any transaction found to lack economic substance. The doctrine lacks a mechanism to respect only the pro rata portion of the tax benefits that corresponds to the ratio of reasonably expected profit from the taxpayer's transaction compared to reasonably expected profit from alternative transactions. *See* Charlene D. Luke, *What Would Henry Simons Do?: Using an Ideal to Shape and Explain the Economic Substance Doctrine*, 11 HOUS. BUS. & TAX L. J. 108, 113 (2011), for an argument that the economic substance doctrine should instead be revised to (among other changes) disallow only the appropriate portion of the taxpayer's claimed tax effects. Such an adaptation of the doctrine might still be within the power of the courts to implement, depending on whether it is foreclosed by the language of section 7701(o).

counterparty and U.S. tax benefits for the U.S. taxpayer.

The fee that each U.S. bank received (the Bx payment)[265] was far less than such bank's gross costs from the transaction (including the U.K. taxes on the trust). That, and not the banks' status as an accommodation party or any moral or policy repugnance of Barclays' U.K. tax planning, was the problem from an economic substance standpoint. But the U.S. banks' function as an accommodation party raises the moral, theoretical issue about whether services to enable someone else's tax strategy are "business" activity that the U.S. tax system should encourage with tax benefits. This raises the old question of whether the U.S. tax system should disadvantage (and attempt to prevent) transactions that it may view as immoral (with respect to taking advantage of a foreign tax system).[266] Such an approach is conceivably within the authority of the courts or the Treasury (by guidance under section 7701(o)), but such an interpretation of the business purpose test appears unlikely, as a practical matter. The business purpose prong focusses on the subjective (business or tax) motives of the U.S. taxpayer whose tax benefits are being challenged, rather than on the motives of the counterparty.

The Treasury could potentially issue a range of guidance on the application of the business purpose test under section 7701(o), under its general authority to issue regulations.[267] Such guidance could even be retroactive (under section 7805(b)(3), which allows retroactive application of regulations in order to prevent abuse), but this is unlikely.[268] Judicial or administrative definitions of business purpose could potentially include an *Esmark*-type thought, which examines whether the taxpayer conducted its business transaction in an unnecessarily complex or costly way, or with more steps than required, in order to obtain tax benefits.[269] Such unnecessary complexity is also one of the theories behind the foreign tax credit generator regulations, issued in response to the STARS transactions.[270]

In summary, there is not much detailed guidance under the case law about what exactly business purpose means, apart from profit expectation. A

---

[265] The U.S. banks also held assets, but that was not incremental business activity attributable to the trust transaction.

[266] *Cf., e.g.*, Treas. Reg. § 1.901–2(e)(5)(iv) (providing foreign tax credit generator regulations, and listing the unrelated counterparty's foreign tax benefit as one factor in a test that can result in disallowing foreign tax credits); I.R.S. Notice 98-5, 1998-1 C.B. 334 (withdrawn) (predicting the issuance of regulations that would disallow foreign tax credits with respect to certain cross-border arbitrage transactions). Both of these examples involve situations in which the U.S. taxpayer claims a foreign tax credit and a counterparty claims a tax benefit from a foreign country, but they are not necessarily limited to situations in which the counterparty's foreign tax benefits are abusive or inappropriate.

[267] *See* 26 U.S.C. § 7805(a) (2016).

[268] In any event, the STARS cases would be unaffected by new guidance. They were decided under old law, because they occurred before the effective date of section 7701(o). *See* 26 U.S.C. § 7701(o).

[269] *See* Esmark, Inc. v. Comm'r, 90 T.C. 171, 195–97 (1988), *aff'd without pub'd op.*, 886 F.2d 1318 (7th Cir. 1989).

[270] *See* T.D. 9416, 2008-2 C.B. 1142, 2008-46 I.R.B. 1142 (2008) (explaining the temporary regulations that preceded the current final regulations).

more extensive definition of business purpose would be very helpful, and the need for such guidance is likely to grow now that section 7701(o) has taken effect. After that effective date, the business purpose prong (under general rules of statutory interpretation) needs to be distinguished from the objective profit analysis, which has not always clearly occurred in the case law.

3. How Much Business Purpose is Sufficient?

The STARS cases give rise to some interesting questions about how much business purpose is sufficient. Under existing guidance (including case law), it is not totally clear how to determine if there is enough subjective business motivation—either in isolation or compared to tax savings motivation —to meet the business purpose prong.

If the Bx payment creates profit,[271] there is a business reason for putting the assets in the trust—but the business reason appears to be half or less of the tax savings motivation, given that such profit is approximately half of the foreign taxes.[272] Is that a sufficient amount of business purpose? The STARS cases squarely raise the issue of whether (before section 7701(o) took effect) a de minimis amount of business purpose is enough.[273] There is also the question of whether the required quantum of business purpose is determined in isolation or in relation to the expected tax benefits—presumably the latter.

If any miniscule amount of business purpose (above zero) were sufficient, then the business purpose test would essentially be moot, because it would be met whenever profit is sufficient to meet the objective prong: any amount of profit (or change in economic position) sufficient to meet the objective prong would presumably be sufficient, almost always, to at least move the "business purpose" finding to above zero. This would mean that a transaction that met the objective prong could not fail the business purpose prong, making the latter test moot for such transactions.[274] The converse would not hold: a transaction that failed the objective test could still theoretically meet the business purpose test. However, a transaction that fails the objective test must fail the economic substance test as a whole (in circuits that use the conjunctive test, under which both prongs must be met, and in

[271] For the STARS transactions, profit results from the Bx payment only if foreign taxes are not treated as a cost.

[272] There is also a foreign tax credit benefit from treating the trust assets' income as foreign source, making the ratio of business motivation to tax savings motivation even lower.

[273] Business purpose that is approximately half the size of the tax motivation for a transaction likely meets some possible standards, but not others. For example, it likely is enough to show that a transaction was not "solely" motivated by tax benefits, but not enough to show that the transaction was "primarily" business motivated.

[274] The *Wells Fargo* jury found that the loan in that case had profit potential but not business purpose, implying that the jury found some meaning for business purpose that was not identical to profit. *See* Wells Fargo II, No. 09-CV-2764, 2017 U.S. Dist. LEXIS 80401, 2017-1 U.S. Tax Cas. (CCH) P50,235 (May 24, 2017) at 3, n.1.

every circuit for transactions after section 7701(o)'s effective date). Thus, the business purpose inquiry would be moot and redundant in such circumstances.

Given that treating any miniscule amount of business purpose as sufficient appears to make the business purpose test moot (at least under the conjunctive test), the subjective prong appears logically to require more than a peppercorn of business purpose—but how much more before section 7701(o) is not clear. Some case law analyses suggest that a very small business purpose is sufficient. The Fifth Circuit states in *Compaq*, for example, that the business purpose test can be met as long as the taxpayer is not "solely" tax motivated, even if it was "primarily" motivated by tax considerations.[275]

Section 7701(o)(1)(B) has provided some guidance on this issue for transactions occurring after March 30, 2010: it requires that "the taxpayer has a *substantial* [business] purpose (apart from federal income tax effects) for entering into . . . [the challenged] transaction."[276] This leaves the question of how "substantial" is defined, especially because this definition of the business purpose prong (unlike the section 7701(o) rule for profit) does not refer to "substantial" as being relative to the amount of expected tax benefits.[277]

4. Future Pressure on Business Purpose Analyses

The business purpose analysis of the economic substance test is currently a gray area, with no easily measurable standards and little in the way of detailed description. It may thus be an area of activity as the economic substance test evolves. The business purpose prong may acquire more prominence in the future, especially because section 7701(o) creates a negative inference, based on rules of statutory interpretation, that the objective and subjective prongs are different from each other, in which case the courts will need to further describe what exactly (other than profit potential) can prove business purpose. Business purpose may also rise in importance if section 7701(o) is determined to constrain the courts' and the Treasury's ability to require more profit than amounts that are "substantial" in relation to tax benefits. In other words, the business purpose test may be the courts' and IRS's last backstop, for tax benefits that appear to go beyond Congressional intent but that meet section 7701(o)'s version of the objective prong.

The business purpose prong may also allow courts to avoid directly

---

275 *See* Compaq, 277 F.3d 778, 781 (5th Cir. 2001).

276 26 U.S.C. § 7701(o)(1)(B) (2016) (emphasis added).

277 *Compare id.* § 7701(o)(1)(B) (requiring that non-U.S. tax purposes must be "substantial"), *with id.* § 7701(o)(2)(A) (requiring that, in order to be taken into account, profit must be "substantial *in relation to the present value of the expected net tax benefits . . .*") (emphasis added).

addressing the conflict between *Compaq* and *IES*, on the one hand, and the STARS appellate cases on the other, regarding the treatment of foreign taxes as a cost in the computation of profit. If courts can focus on the business purpose prong, and if they find that a transaction fails that prong, then the transaction fails the economic substance test without the need to address the objective prong (because transactions are required to meet both prongs after section 7701(o) takes effect, and before that in jurisdictions that apply a conjunctive test).

The *Wells Fargo* case is a good illustration of this possibility. *Wells Fargo* has been appealed to the Eighth Circuit, which held in *IES* that foreign taxes are a not a cost for purposes of computing profit under the economic substance analysis.[278] The *Wells Fargo* jury found that the trust transaction lacked profit potential.[279] The jury reached that conclusion partly on the grounds that the Bx payment was not income, but it is unclear to what extent the jury also determined that the trust's U.K. taxes were a cost (perhaps distinguishing *IES* on factual grounds). Unless it either distinguishes *IES* or reconsiders its view of this issue, the Eighth Circuit is unlikely to treat the trust's U.K. taxes as a cost, in computing profit from the STARS transaction. In that case, the only way to treat the STARS transaction as lacking profit is to conclude that the Bx payment is not income.

If, on appeal to the Eighth Circuit, the STARS transaction is treated as having sufficient profit potential,[280] then there are only two other ways to find that the transaction lacks economic substance. First, the transaction may lack business purpose (the subjective prong), which helps the government under the conjunctive or flexible versions of the test. Secondly, the transaction may violate the intent of the foreign tax credit statute (if one argues that the intent of the statute is a separate inquiry, apart from the objective and subjective prongs). Thus, given the government's possible loss on the objective prong in the *Wells Fargo* litigation upon appeal (because of the *IES* precedent in the relevant circuit), the business purpose prong is likely to be crucial in *Wells Fargo* on appeal, as one of the few ways that the government can still prevail on economic substance.[281]

---

[278] *See* IES, 23 F.3d 350, 354 (8th Cir. 2001).

[279] *See* Wells Fargo II, No. 09-CV-2764, 2017 U.S. Dist. LEXIS 80401, 2017-1 U.S. Tax Cas. (CCH) P50,235 (May 24, 2017) at 3, n. 1.

[280] This would essentially require the court to find both that the U.K. taxes are not treated as a cost and that the Bx payment is treated as income.

[281] Winning the business purpose prong in *Wells Fargo* on appeal (while losing the objective prong) would only allow the government to prevail on the economic substance issue if the Eighth Circuit decides to apply the conjunctive or the flexible version of the test. The Eighth Circuit has never had to decide which version of the test to apply, because it has never determined that any specific fact pattern met one prong but not the other. *See* IES, 253 F.3d 350, 353-54 (8th Cir 2001). If the Eighth Circuit instead applies the disjunctive test, the taxpayer need only win one prong—objective or subjective—to prevail, in which case a taxpayer victory on the objective inquiry would be sufficient to reject an economic sham challenge, even if the government won the business purpose prong. If the court adopts the flexible approach, as expected by *Wells Fargo II*, the results are harder to predict. As discussed above, in future cases to which

In summary, there may be much more pressure in the future on the business purpose test, which has not been emphasized in most cases and has rarely been the deciding factor.[282] It has not been prominent partly because it is usually strongly tied to the profit analysis, and seldom reaches a different result than the objective prong. But section 7701(o) now implies that the subjective prong must differ from the objective prong. Further, in economic substance cases that challenge foreign tax credits, given the circuit split on the issue of whether foreign taxes are treated as a cost in the profit calculation, the government and courts may be moved to put more emphasis on (and refine further) the business purpose test. Resulting changes to the business purpose test may affect the analysis of other economic substance fact patterns, beyond the foreign tax credit context.

IV. ALTERNATIVE APPROACHES

A. Overview

The economic substance doctrine can be seen as a weapon of last resort, when no legislative or regulatory rule applies, by its literal terms, to prevent a tax benefit that was not intended by Congress. As demonstrated above, the economic substance doctrine is not ideal, in many ways: it tends to be a little vague and unpredictable, and (at the moment) the circuit split on the treatment of foreign taxes creates some uncertainty with respect to foreign tax credit cases. In the interest of predictability and certainty, it seems prudent to investigate current and possible future alternatives to the economic substance doctrine. Even though the foreign tax credit generator regulations[283] have already taken effect, there may be future foreign tax credit transactions, different from STARS, that escape the detailed rules of such regulations while still appearing to conflict with the purpose of the foreign tax credit. Possible future alternatives to the current economic substance doctrine, as a means of addressing such foreign tax credit transactions, can be grouped into three categories: (1) possible refinements of certain existing foreign tax credit rules: the subsidy, compulsory payment, and legal liability rules; (2) possible future guidance to refine the economic substance doctrine; and (3) possible new approaches: section 901(k)-like or FOGEI-like rules. Each is discussed in turn below.

B. Possible Refinements of Existing Foreign Tax Credit Rules: Subsidy,

section 7701(o) applies, taxpayers will not be able to win an economic substance case without winning the business prong.

[282] *See* Wells Fargo I, 143 F. Supp. 3d 827, 834 (D. MN. 2015) (stating that the Eighth Circuit has never found that one prong was met and the other was not); *Wells Fargo II*, No. 09-CV-2764 at 8-9 (stating that there appear to be no cases in which a transaction is found to be an economic sham solely because it fails the subjective prong, no matter how the courts describe the economic substance test).

[283] *See* Treas. Reg. §1.901-2(e)(5)(iv).

Compulsory Payment, and Legal Liability

1. A Basic Subsidy Argument Could Be Made Under Current Law or with Additional Guidance

The subsidy rule provides that a foreign tax is not creditable if it is used by the foreign country to provide a subsidy (a benefit of any kind, including a credit) to the taxpayer, a related person, a counterparty, or a counterparty to a related transaction, but only if the subsidy is computed by reference to the amount of the foreign tax or the amount of the foreign tax base.[284] In the STARS transactions, Barclays received a U.K. tax credit for the amount of the trust's tax, and used that credit against its own U.K. corporate income tax. Thus, it received a foreign-law benefit (which the subsidy regulation defines as including a credit) that was computed by reference to the trust's U.K. tax.

The subsidy rule arguably made those taxes non-creditable to the U.S. bank, because the trust's taxes were used by the U.K. to provide a benefit to a related party or to a counterparty to a related transaction. First, Barclays was a counterparty to a related transaction (a transaction related to the event that generated the U.K. tax). The event that caused the U.K. tax was the assets' generation of income while those assets were held in a trust that had a U.K. trustee (or, depending on how one views it, the placement of existing assets into a trust and the appointment of the U.K. trustee). Barclays had a relationship with the trust that included receiving periodic distributions from the trust, from that income (although those distributions were automatically recontributed to the trust). The loan from Barclays to the U.S. bank was also integrally related to the trust, and stemmed from Barclays' obligation to resell its interests in the trust after a set period (in combination with other agreements).

In addition, Barclays was a "related party" to the U.S. bank within the meaning of the subsidy rules, which use the very broad section 482 meaning of "related."[285] Applying the section 482 regulations, a related person includes a person under common "control resulting from the actions of two or more taxpayers acting in concert or with a common goal or purpose."[286] Because Barclays and the U.S. bank acted together to conduct the STARS transaction, with a common purpose of obtaining tax benefits for both of them, Barclays pretty clearly fits within that broad definition of "related." The trust's U.K. tax thus appears to literally fall within the

[284] 26 U.S.C. § 901(i) (2016); Treas. Reg. § 1.901-2(e)(3) (2016).

[285] *Id.* § 901(i) (referring to "a related person (within the meaning of section 482)"); Treas. Reg. § 1.901-2(e)(3)(A) (defining "related person" as "within the meaning of section 482").

[286] Treas. Reg. § 1.482-1(i)(4); *see also id.* § 1.482-1(i)(5). Section 482 does not use the word "related." *See* 26 U.S.C. § 482. It uses the word "controlled," which is defined broadly by the regulations, using a definition that includes the language quoted in the text. *See id.*; Treas. Reg. § 1.482-1(i)(4).

language of the subsidy rule.

The government did not raise the subsidy issue in the STARS cases as a reason for disallowing the foreign tax credit.[287] This is probably because there has been some discussion (in case law and rulings) about the interaction between the subsidy rule and imputation systems (also known as integrated tax systems). Imputation systems impose tax on corporations' income, but then give the corporations' shareholders a full or partial credit for their corporations' taxes (to reduce the shareholders' own income taxes) when the shareholders receive corporate distributions. Under the U.K. view, Barclays was allowed an imputation credit for the trust's tax against Barclays' own tax, because the U.K. treated Barclays as a unit holder in the trust. The U.S. foreign tax credit regulations reserve on the issue of integrated tax systems, although this reservation appears outside of the subsidy rule.[288]

The Tax Court has held that where liability for one tax ("first levy") is offset by a credit for a second tax ("second levy"), the situation falls within the "multiple levy rule" of the regulations rather than the subsidy rule.[289] The multiple levy rule provides that where a taxpayer can use the second levy to offset the first levy, the taxpayer is treated as paying the second levy in its entirety, and as paying the first levy to the extent that it exceeds the second levy.[290] Thus, although such offsetting situations literally fall within the subsidy rule (because the foreign country provides a credit to the taxpayer based on the amount of the second levy), the multiple levy rule implies that the second levy (used as a credit against the first) does not become non-creditable under the subsidy rule. The regulations thus imply (without clearly stating) that the multiple levy rule overrides the subsidy rule.

---

[287] The government did not assert, and the STARS cases did not address, the argument that the trust's taxes were not eligible for a U.S. foreign tax credit (for the U.S. bank) because the trust's U.K. taxes were used to provide a credit against Barclays' U.K. tax. Some of the opinions do address the subsidy rule in the context of the treatment of the Bx payment. They discuss whether the government's concession that the Bx payment (not the trust's U.K. tax) was not a subsidy means that the Bx payment has "substance," is not an effective rebate of a tax benefit, and should be treated as income. *See supra* notes 237-239 and accompanying text. That argument about treatment of the Bx payment as income (or not) under the economic substance doctrine is a different point than the basic application of the subsidy rule (under the Code and regulations, without the need for an economic substance argument) to disallow a credit for the trust's tax. *See, e.g.,* Wells Fargo, 143 F. Supp. 3d 827, 839 (D. MN. 2015) (analyzing the treatment of the Bx payment and stating that "As Wells Fargo points out, the government has never contended that § 901(i) [the subsidy rule] applies in this case, and thus the government has effectively conceded that § 901(i) does not bar Wells Fargo from claiming foreign-tax [sic] credits."); Santander I, 977 F. Supp. 2d at 51.

[288] *See* Treas. Reg. § 1.901-2(e)(4)(ii).

[289] *See* Compaq Computer Corp. v. Comm'r, 113 T.C. 363, 374 (1999) (*Compaq ACT*) (addressing U.K. Advanced Corporation Tax (ACT) imposed on a parent corporation and then surrendered by that corporation to its subsidiary, which used the ACT as a credit against the subsidiary's tax). (This case is not to be confused with another foreign tax credit case involving the same Compaq Computer Corporation, discussed above: Compaq, 277 F.3d 778 (5th Cir. 2001)). Another case addressing the U.S. creditability of the same U.K. ACT tax, with respect to another taxpayer, does not discuss the subsidy issue. *See* Xerox Corp. v. United States, 41 F.3d 647 (Fed. Cir. 1994) (*Xerox*), *reh. denied* 1995 U.S. App. Lexis 3101, *cert. denied* 516 U.S. 817 (1995), *non acq.* AOD CC-1997-001, 1997 AOD Lexis 1.

[290] *See* Treas. Reg. § 1.901-2(e)(4)(i) (providing the multiple levy rule).

The multiple levy rule, however, only describes situations where the same taxpayer pays or accrues both levies—not situations where one taxpayer's tax is used as a credit against another taxpayer's tax. But the *Compaq ACT* case has interpreted the multiple levy as applying, "by analogy," where a parent corporation's foreign tax was used as a credit against its subsidiary's foreign tax.[291] That court concluded that the subsidy rule therefore did not apply. In addition, two non-binding IRS rulings (in 1994 and 2005) declined to apply the subsidy rule to an imputation system (in which a corporation's tax was used as a credit against its shareholder's tax). The 2005 ruling suggested that the IRS "should not argue that the imputation credit [in an un-named foreign country, not identified in the redacted ruling] constitutes a subsidy."[292] The ruling did not say that the IRS could not make a subsidy argument, but that it *should* not.[293] The earlier of the two rulings, in 1994, said that "[i]ntegrated systems are unique and cannot be analyzed under the existing §901 regulations dealing with refunds or subsidies."[294]

The 1994 ruling concluded, however, that such integrated systems (involving a foreign tax paid by one person, and used as a second person's credit under foreign law) should be treated for U.S. foreign tax credit purposes as if the first person pre-paid the second person's foreign tax.[295] In other words, in the ruling's view, the tax used as a credit under foreign law should not be creditable (in the U.S., under the foreign tax credit rules) to the first person (treated as prepaying for another), but to the second. Even though this ruling does not apply the subsidy rule, it still makes the foreign tax non-creditable (in the U.S.) to the first taxpayer (the equivalent of the U.S. bank, in the STARS fact pattern).

The *Compaq ACT* case and one of the rulings argue that the use of one person's foreign tax as a credit against the foreign tax of another, related person does not fall within the policy of the subsidy rule, as articulated by Congress, and that therefore this is not an appropriate instance to apply the subsidy rule.[296] They describe Congress as wanting to avoid granting a credit where a foreign tax is theoretically paid, but is actually rebated (in substance). In other words, they describe the subsidy statute as aiming for situations where the value of the foreign tax paid is not actually retained by the foreign government, but is instead returned to the taxpayer (or to a related person, a counterparty, or a counterparty to a related transaction). However, such a

[291] *See Compaq ACT*, 113 T.C. at 374.

[292] *See* I.R.S. C.C.A. 200532044 (August 12, 2005); *see also* 1994 WL1866022, 1994 FSA Lexis 423, at D (June 23, 1994).

[293] I.R.S. C.C.A. 200532044 (August 12, 2005).

[294] I.R.S. F.S.A. 1994 WL 1866022, 1994 FSA Lexis 423 at C (June 23, 1994).

[295] *Id.* at C, D.

[296] *See Compaq ACT*, 113 T.C. at 374-75; I.R.S. C.C.A. 200532044 (August 12, 2005). Note that any Congressional statement of intent post-dates the regulations. In an unusual twist, the subsidy regulations were issued before the subsidy rule was added to the Internal Revenue Code of 1986. Therefore, Congress' articulated purpose might not exactly mirror the *regulations*' original purpose.

standard (regarding whether the value of the foreign tax is retained by the foreign country) is not actually stated or measured in the statutory or regulatory versions of the subsidy rule, both of which instead apply whenever any benefit— including a credit—is given to any of the listed persons and is computed based on the foreign tax or the foreign tax's base.[297]

In addition, it is arguable that a foreign government in an imputation system—or in the STARS cases—does *not* retain the value of the foreign tax that is used to offset another person's foreign tax, and therefore the offsetting foreign tax (used to reduce another tax) should become non-creditable under the subsidy rule (even under the policy argument described above). For example, in the STARS cases, the U.K. had the right to collect $22 from the trust (from its trustee, to be specific) and $30 from Barclays for every $100 of income generated by the trust's assets (using the numbers from the courts' examples).[298] Without the imputation credit, the U.K. had the right to retain an aggregate of $52 from those two amounts. Instead of retaining an aggregate of $52 from the trust and Barclays, the U.K. retained an aggregate of $30 (because it gave Barclays a credit of $22, reducing Barclay's corporate income tax from $30 to $8). So it is arguable that, because the U.K. accepted $30 of tax rather than $52 (by reason of the credit for the trust's tax), the U.K. did not retain the $22 of the trust's tax.[299]

The subsidy regulation uses "[s]ubstance and not form"[300] to determine whether a benefit is granted, and money (including the $22 of the trust's tax) is fungible. Therefore, the labels on the taxes paid by the trust and Barclays—the fact that, in form, the U.K. granted a credit to Barclays rather than refunding the trust's $22 of tax to Barclays or to the trust—should not determine whether the $22 was retained by the U.K. One could also note that if Barclays had zero U.K. corporate tax for the year (for example, if it had net losses due to other transactions), it is not clear whether the U.K. would have refunded the $22 of the trust's tax to Barclays (which would show that the intent of the imputation system was that the U.K. Treasury not retain the trust's tax, but that it would return the value of the trust's tax to Barclays by one means or another) or whether Barclays would have lost the value of the $22 or would have been able to use it only as a credit against future corporate income tax, if any. The latter would be more helpful to a taxpayer argument that the U.K. imputation system applicable to trust unit holders was intended to retain the value of the $22 (and that the policy of the subsidy rule therefore

[297] *See* 26 U.S.C. § 901(i); Treas. Reg. § 1.901-2(e)(3).

[298] These are the hypothetical numbers from the simplified example used by *Salem II* and repeated (with adaptations) but the other appellate courts. *See supra* note 55 and accompanying text.

[299] This example ignores the impact of Barclays' other U.K. tax benefits. Taking them into account would only demonstrate that the U.K. retained even less tax.

[300] Treas. Reg. § 1.901-2(e)(3)(ii)(2016) ("Substance and not form shall govern in determining whether a subsidy exists. The fact that the U.S. taxpayer may derive no demonstrable benefit from the subsidy is irrelevant in determining whether a subsidy exists.").

is not implicated).

In any event, it is not clear that the *Compaq ACT* case[301] and the two IRS rulings, all declining to apply the subsidy rule to an imputation credit provided to a related party, apply in the STARS fact pattern (or to certain other foreign tax credit transactions): those two rulings and the case apply where the taxpayer whose tax is used as a credit, and the taxpayer using the credit, are parent and subsidiary, *i.e.*, closely related. They do not address a situation where one taxpayer (for example, Barclays) uses the tax of an unrelated taxpayer (for example, the U.S. bank) as a credit under foreign law.[302] Reading such unrelated-party situations out of the subsidy rule would make the word "credit" in the regulatory version of the rule meaningless. Despite the Code rule regarding "subsidy by any means"[303] and the regulatory rule applying to "a subsidy by any means (including . . . a credit . . .)",[304] a credit based on the amount of a foreign tax could never result in a subsidy if one took the broader reading of *Compaq ACT* and the two rulings, and argued that these authorities were not limited to related parties. This, therefore, does not seem like the best reading or application of *Compaq ACT* and the two rulings. (The rulings are non-binding in any event, but the *Compaq ACT* case was issued by the Tax Court and is therefore potentially even more broadly applicable, to more taxpayer litigants, than a case issued by a district court.) Instead, one could at least narrow *Compaq ACT* and the two rulings to situations in which the party paying the foreign tax and the party using such tax as a credit are closely related (for example, parent and majority-owned subsidiary, as was the case in all of those fact patterns).

Alternatively, one could argue that *Compaq ACT* and the two rulings are limited to situations that the U.S. views as an imputation credit, *i.e.*, situations in which the U.S. views the foreign-law credit recipient as a shareholder (rather than as a lender or as having another kind of relationship to the foreign-tax-owing entity).[305] A consistent string of other non-binding rulings takes this approach.[306] They address fact patterns under the Italian

---

[301] It is also not clear that the *Compaq ACT* case was correct to apply the multiple levy rule "by analogy," when such rule only literally applies where one taxpayer pays or accrues both the first and second levies (both the tax used as a credit and the tax offset by such credit).

[302] The definition of "related" under the subsidy regulation is very broad. *See supra* text accompanying notes 286-87. But *Compaq ACT* and the two rulings are trying to find the subsidy rule inapplicable (rather than applying the rule and using its definitions). The multiple levy rule (which they apply instead) has no concept of related parties. *See* Treas. Reg. § 1.901-2(e)(4)(i). As explained above, the multiple levy rule literally only applies where the same taxpayer has the liability for both levies.

[303] 26 U.S.C. § 901(i)(1).

[304] Treas. Reg. § 1.901-2(e)(3)(i)(A).

[305] The *Compaq ACT* court bases its reasoning partly on the presence of an imputation system. The court notes that the reserved regulatory paragraph relating to imputation systems appears in the multiple levy rule, rather than in the subsidy rule. It takes this as a sign that "that Treasury must also believe that such systems are closer to multiple levies than subsidies." *See* Compaq ACT, 113 T.C. 363, 374 n.8 (1999); *see also* Treas. Reg. § 1.901-2(e)(4)(ii).

[306] *See* I.R.S. F.S.A. 1996 WL 33321172 (June 28, 1996); I.R.S. F.S.A. 1996 WL 33320880 (July 1, 1996); I.R.S. F.S.A. 1997 WL 33314841 (July 10, 1997); I.R.S. F.S.A. 1998 WL 1984786 (March 4, 1998).

imputation system, where Italian law saw a person as a shareholder of a corporation, and granted them a credit for the corporation's tax. However, U.S. law saw the same person as a lender, rather than as a shareholder. The rulings conclude that for U.S. tax purposes, this was not an imputation credit (despite the Italian law's reference to imputation and the Italian view that the credit recipient was a shareholder), because U.S. law did not view the Italian credit as being granted to a shareholder. Therefore, the rulings conclude that the Italian fact pattern is not within the reserved paragraph on imputation systems in the foreign tax credit regulations.[307] They find that the use of the corporation's Italian tax to provide a credit to the lender (not a shareholder in the U.S. view) falls within the subsidy rule and makes the corresponding amount of the corporation's tax (the amount used as a credit to the lender) non-creditable (to the corporation or its owners) for U.S. foreign tax credit purposes.

The same reasoning applies to the STARS transactions: Barclays was not an owner of the trust in the U.S. tax system's view, but a lender (even though U.K. law saw Barclays' role differently). Therefore, in the U.S. tax view, the credit that Barclays received for the trust's taxes was not a credit provided to a shareholder for its corporation's tax amounts (or to any owner for its entity's tax). Under the reasoning of the string of rulings on the Italian imputation system, the U.K. credit provided to Barclays was not an imputation credit (in the U.S. view) and is therefore appropriately treated as a subsidy under the subsidy regulation.

More concerning is the question of whether, if the subsidy rule applies where one person's tax is credited against the tax of another person, there may be too little aggregate creditable foreign tax, when one adds up the creditable foreign tax in all of the parties' hands. In other words, if X is paid to the foreign country, is there some portion of that X that becomes non-creditable to every one (and creditable to no one), by reason of the subsidy rule? For example, in the STARS cases, for every $100 of the trust's income that is taxable by the U.K., one could be left with $8 of potentially creditable U.K. tax (the $30 of Barclays' corporate income tax less the $22 credit that Barclays receives for the trust's tax), rather than $30 (the net amount retained by the U.K. Treasury). The remaining $22 of U.K. tax is not creditable to the U.S. bank (because of the subsidy rule), and it is not creditable to Barclays (arguably) because Barclays does not have legal liability for that amount.[308]

This could be addressed by viewing the $22 as a prepayment (by the trustee) of Barclays' tax, which is the IRS's preferred viewing of imputation

[307] *See* Treas. Reg. § 1.901-2(4)(ii).
[308] *See* Treas. Reg. § 1.901-2(f)(1) (providing legal liability rule).

credits generally[309] (although the STARS cases do not present an imputation credit fact pattern in the view of the U.S. tax system). The government lost the argument for such a view of imputation credits in *Compaq ACT* and *Xerox*, but those cases focused on the effect of the U.S.-U.K. tax treaty.[310] That treaty specifically granted a credit for an amount based on the Advanced Corporations Tax (ACT) to the corporation on whom the ACT was imposed (rather than to the related corporation using the ACT as a credit). The same result might not apply without a tax treaty that addresses the particular foreign tax that is usable as a credit or offset (under foreign law) and identifies the party eligible for a credit under U.S. law for that particular tax.

Perhaps the Treasury could achieve (or clarify) this pre-payment effect by means of guidance, in order to be fair (ensuring that every dollar of foreign income tax paid was potentially creditable by someone) while also implementing the regulatory reference to credits (as "benefits") in the subsidy rule.[311] Such guidance could state that where the offsetting levy of one person is used as a credit against the offset levy of another person (at least where the two persons are not related to each other), the offsetting levy is not a creditable foreign tax to the first person (who originally has the legal liability for it). Guidance could clarify that such offsetting levy is instead treated as a prepayment of the offset levy. The taxpayer who uses the foreign-law credit (for the offsetting levy) against the other (offset) foreign tax (Barclays, in the STARS cases) could thus potentially be eligible for a U.S. foreign tax credit for the offsetting levy (the trust's taxes), which would be treated as paid by the other taxpayer (the U.S. bank or the trustee). (Payment by another taxpayer is not an impediment to claiming the foreign tax credit.)[312] The taxpayer who uses the foreign credit (Barclays) would have income, in theory, by reason of the other person's prepayment of such crediting taxpayer's foreign tax,[313] but that seems to be appropriate.

This approach results in the correct amount of aggregate creditable tax, and the apportionment of such creditable tax (potentially) among the correct parties for U.S. foreign tax credit purposes. Such an approach would not help the STARS parties, however: it would leave the U.S. bank with no creditable tax, because the $22 of the trust's U.K. tax would not be creditable to the U.S. bank, due to the subsidy rule (because the $22 is used to provide a U.K. credit to Barclays). Theoretically, Barclays then has $30 of creditable U.K. tax for U.S. foreign tax credit purposes ($8 that it paid to the U.K. and $22 that the trust or trustee pre-paid to the U.K. on Barclays' behalf). That

[309] *See Compaq ACT*, 113 T.C. at 367; I.R.S. F.S.A 1994 WL 1866022, 1994 FSA Lexis 423 (June 23, 1994) (discussing German imputation credits granted to shareholders for their corporations' German taxes).
[310] *See Compaq ACT*, 113 T.C. at 370-72; Xerox, 41 F.3d 647, 652-53, 660 (Fed. Cir. 1994).
[311] *See* Treas. Reg. § 1.901-2(e)(3) (providing subsidy rule).
[312] *See* Treas. Reg. § 1.901-2(f)(1)-(2).
[313] *See* Old Colony, 279 U.S. 716, 729 (1929).

potential U.S. foreign tax credit is not useful to Barclays because it (presumably) is not eligible for a U.S. foreign tax credit itself under section 906[314] and it is not a controlled foreign corporation (CFC)[315] that can generate an indirect foreign tax credit for its U.S. shareholders.[316]

Applying the subsidy rule to situations where the foreign counterparty's tax benefit is computed by reference to the U.S. person's foreign tax (the same foreign tax that the U.S. person would otherwise claim as a foreign tax credit) has the potential to deter foreign tax credit arbitrage transactions by making foreign taxes non-creditable for such U.S. person (as an alternative to the economic substance approach, and in situations where the foreign tax credit generator regulations[317] do not apply). That deterrence might last until taxpayers figure out a way to derive a benefit from the foreign counterparty's taxes in the U.S. For example, if the foreign counterparty is a CFC, then U.S. shareholders of the counterparty will potentially be able to derive a benefit from the counterparty's foreign taxes through the U.S. foreign tax credit.[318]

In summary, it is not clear that the government was required to forego the subsidy argument in the STARS cases, when such argument might have been simpler, and with fewer gray areas, than the economic substance doctrine. In the future, the subsidy rule could be an effective weapon for the government in cross-border arbitrage fact patterns involving foreign tax credit claims, because many of such transactions depend on a foreign tax system's benefit to the foreign unrelated counterparty (based on the amount of the U.S. person's[319] tax or the tax base of such tax) as a way to divide the economic burden of such foreign tax between the U.S. person and the counterparty.[320] To unrelated parties, and where U.S. law does not see a shareholder or other owner receiving an imputation credit, the subsidy rule arguably applies now, even without further guidance that clarifies the effect of the subsidy rule on situations where a foreign government uses one foreign levy as a credit against another.[321] However, such guidance would provide greater certainty

[314] *See* 26 U.S.C. § 906 (2016) (allowing a U.S. foreign tax credit to foreign persons in certain circumstances).

[315] *See id.* §957(a).

[316] *See* 26 U.S.C. §960.

[317] *See* Treas. Reg. § 1.901(e)(5)(iv).

[318] *See generally* 26 U.S.C. §960.

[319] The reference to the U.S. person, above, includes the U.S. person's controlled foreign corporations, because the U.S. person can potentially obtain a foreign tax credit for such foreign subsidiaries' foreign taxes. *See generally id.*

[320] Both former Notice 98-5 and the foreign tax credit generator regulations focused on cross-border arbitrage as one indicator of a problematic foreign tax credit claim. *See* I.R.S. Notice 98-5, 1998-1 C.B. 334 (withdrawn); *see also* Treas. Reg. § 1.901-2(e)(5)(iv) (2016) (providing foreign tax credit generator regulations).

[321] The subsidy rule might also apply to related parties, even without further guidance, on a literal reading of the subsidy regulation (except in the Fifth Circuit, which decided the *Compaq ACT* case). Even the approach of treating one person as prepaying another's foreign tax (even for related parties) could potentially be used by the government without additional guidance.

and predictability. Guidance could also ensure that the aggregate amount of creditable foreign tax allocated to all parties (for U.S. foreign tax credit purposes) in such situations is equal to (not less than) the total amount of such foreign tax paid by all of such parties.

2. The Compulsory Payment Rule

The compulsory payment rule in the Treasury Regulations generally provides that a foreign tax is not creditable, because it is a voluntary payment, if the taxpayer fails to pursue all "effective and practical remedies" to reduce reasonably expected foreign tax as much as possible.[322] However, the compulsory payment rule does not require a taxpayer to change "its form of doing business, its business conduct, or the form of any business transaction in order to reduce its liability under foreign law for tax."[323] The compulsory payment rule is meant to prevent the foreign tax credit from making taxpayers willing to incur unnecessary foreign tax. As a simple example, assume that foreign country X audits a U.S. taxpayer's foreign subsidiary, and asserts that the subsidiary owes an additional $Y of foreign tax. The taxpayer might be inclined to pay the additional $Y without contesting the assessment, if it expects that it can obtain a U.S. foreign tax credit for the full $Y amount. In other words, the expected foreign tax credit could make the taxpayer indifferent to whether or not it pays additional foreign tax. However, because of the compulsory payment rule, such a taxpayer is required to pursue all remedies for which the cost is reasonable (determined based on the amount at stake and likelihood of success)[324] to reduce the asserted $Y amount as much as possible, using a reasonable application of country X law. The IRS has traditionally been relatively aggressive about enforcing the compulsory payment rule.[325] It has also consistently argued that the business conduct exception applies only to "business" conduct, not tax elections or other non-business actions.[326]

Potentially, the government could have argued that the trust's taxes from the STARS transaction were non-creditable because of the compulsory payment rule, on the theory that the U.S. bank subjected its assets to U.K. tax voluntarily, and did not pursue "all effective and practical remedies" to avoid or reduce such U.K. tax (such as not appointing its own U.K. subsidiary as

---

[322] *See* Treas. Reg. § 1.901-2(e)(5)(i).

[323] *See id.* This is sometimes colloquially referred to as the "business conduct rule."

[324] *See id.*

[325] *See, e.g.*, Proctor & Gamble v. United States, 570 F. Supp. 2d 972, 977 (S.D. Ohio 2008).

[326] *See, e.g.*, I.R.S. Tech. Adv. Mem. 200807015 (Feb. 15, 2008) (finding that agreement to surrender loss to U.K. counterparty was not "part of the form of the business transaction" even if it was necessary in order to reach agreement with the counterparty); I.R.S. F.S.A. 200049010 (Dec. 8, 2000) (holding that an election on when to pay Danish tax was not "business conduct"); I.R.S. C.C.A. 200920051 (May 15, 2009) (indicating that an election to treat entities as transparent under Italian tax law was not a "form of doing business"); *see also* Rebecca Rosenberg, *Foreign Flow–Through Election's Effect on Noncompulsory Tax Treatment*, 59 TAX NOTES INT'L 203 (2010).

the trustee regarding U.S.-located assets).[327] The government did not make this argument. Presumably, it worried that it would lose under the business conduct rule if the taxpayer argued that holding the income-producing assets was a business transaction, and that the compulsory payment rule therefore does not require the taxpayer to alter the form or structure of that transaction in order to reduce U.K. tax. In other words, the taxpayer would have argued that the compulsory payment rule cannot address the fact that it chooses a trust and a U.K. trustee as the form or structure of its business conduct or business transaction (holding the assets). The foreign tax credit generator regulations address this concern by stating outright that they treat certain foreign taxes as non-compulsory notwithstanding the basic compulsory payment rule—in other words, the foreign tax credit generator regulations are an exception to the business conduct rule.[328] (But such regulations' effective date does not apply to the STARS transactions.)

Theoretically, even where the foreign tax credit generator regulations (and their six precise factors) do not apply, the Treasury and IRS could argue that the compulsory payment rule nonetheless bars credits in situations like the STARS transactions. The government could argue that the business conduct exception ("[the] taxpayer is not required to alter its form of doing business, its business conduct, or the form of any business transaction"),[329] even as it is currently written, applies to an incremental step by the taxpayer only if that incremental step (apart from related transactions) is itself "business" conduct with non-tax consequences. For example, it could have argued that placing the assets in the trust, and appointing a U.K. trustee, were not "business conduct" or "business transactions" because they had no non-tax effects and no potential for profit (if foreign taxes are treated as a cost), even though holding the assets was itself business conduct.

However, even such an incremental approach may fail if the taxpayer's actions have non-tax effects under U.S. or foreign law, such as making U.K. law applicable in determining creditor's rights with respect to the trust, or making the trust's assets potentially subject to U.K. government enforcement actions. The government could have responded, though, that the STARS parties' careful contracts, indemnification clauses, and negotiated options for terminating the transaction if anything went wrong all combined to reduce any potential non-tax impacts (including non-tax corporate law, bankruptcy, and jurisdictional consequences) to a de minimis level. The

[327] This voluntary subjection of the assets' income to U.K. tax was one of the main points that disturbed the courts and the government. *See, e.g.*, Salem I, 112 Fed. Cl. 543, 585 (2013) (emphasizing that the U.S. taxpayer voluntarily subjected its income (from the trust's assets) to U.K. tax, without changing anything else, in order to trigger foreign tax credits: "BB&T used the Trust structure to subject its income from assets in the United States to tax in the United Kingdom without otherwise altering that income or its management and control of the assets"); Santander III, 844 F.3d 15, 24 (1st Cir. 2016) (referring to "deliberate incurring of Sovereign's U.K. tax liability.").

[328] *See* Treas. Reg. § 1.901-2(e)(5)(iv)(A) (2016).

[329] Treas. Reg. § 1.901-2(e)(5)(i).

extent of the non-tax impact of placing the assets in the trust and appointing a U.K. trustee isn't fully apparent from the STARS opinions, and would be a question of fact (likely affected by provisions of U.K. law).

The Treasury and IRS could consider revising the "business conduct" exception to clearly express the concept that a separable step (such as placing assets in a trust with a U.K. trustee) that does not impact the business utility of an asset, transaction, or conduct, may be tested separately under the compulsory payment rule and its business conduct exception. They could also contemplate a new rule that provides that a business impact (such as subjecting assets to possible future U.K. enforcement actions) that is relatively de minimis (compared to the expected increase in foreign taxes) is not sufficient to bring a transaction within the business conduct exception. Such a rule would be consistent with the general theory that the compulsory payment rule is intended to cause taxpayers to act as vigorously to reduce foreign tax as they would in the absence of a foreign tax credit. If the business conduct rule were thus removed as an applicable exception for transactions like STARS, the default provisions of the compulsory payment rule appear to apply to such transactions, in which case the foreign tax credits could be disallowed by treating the foreign taxes as voluntary payments.

3. Legal Liability

The "legal liability rule," with its challenges, lurks in the shadows of the STARS cases. The legal liability rule (also called the "technical taxpayer rule") provides that the person treated as paying a foreign tax, for purposes of the foreign tax credit rules, is "the person on whom foreign law imposes legal liability for such tax . . . ."[330] Because the test for determining which person is eligible for the foreign tax credit is "legal liability," and not economic burden, U.S. taxpayers who do not bear the full economic cost of the foreign tax can sometimes be eligible for the credit, as in the STARS cases[331] and *Nissho Iwai*.[332]

This can lead to troubling results that appear to conflict with the intent of the foreign tax credit. The purpose of the foreign tax credit is (generally) to give $1 of credit against U.S. tax for every $1 of foreign income tax borne by the taxpayer on the same type of foreign source income, in order to prevent the taxpayer from bearing the cost of double tax (U.S. and foreign) on the same foreign source income.[333] If the U.S. taxpayer does not bear $1 of

[330] *Id.* §1.901-2(f)(1).

[331] *See, e.g.*, Santander I, 977 F. Supp. 2d 46, 53 (D. MA. 2013) (discussing the legal liability rule and the fact that such rule does not consider economic burden as supporting the U.S. bank's entitlement to the foreign tax credit: "Even if the Barclays payment was intended to be and was the assumption of part of Sovereign's U.K. tax burden . . . Sovereign is nonetheless treated as having paid the full U.K. tax for purposes of the foreign tax credit.").

[332] *See* Nissho Iwai, 89 T.C. 765, 776 (1987).

[333] *See supra* note 35.

economic burden for the $1 of foreign income tax, there does not seem to be a policy reason to give such taxpayer $1 of foreign tax credit (although one could discuss the need to protect the competitiveness of U.S. businesses). Economic burden (or the taxpayer's lack thereof) for the foreign tax seems to be part of what bothers the courts and the government about the STARS cases.[334]

The STARS cases show fact patterns in which taxpayers try to achieve a foreign tax credit that exceeds their economic burden for the tax, gaining an affirmative benefit from the credit rather than mere neutrality. Thus, the *Salem I* court noted that "[t]he transaction became immensely profitable to BB&T when it claimed U.S. foreign tax credits for a U.K. tax cost that it had not in substance paid."[335] In the STARS cases, the U.S. bank and Barclays shared the economic burden of the trust's U.K. taxes between them, by means of the Bx payment (which was computed by reference to the amount of U.K. tax on the trust's income).

As discussed above,[336] such instances of foreign tax credits without the taxpayer bearing the economic cost of the foreign taxes are not limited to the STARS cases. Perhaps it is time for the Treasury and IRS to reconsider whether the legal liability rule is the best possible determinant of eligibility for a foreign tax credit in all fact patterns. The government issued proposed regulations in 2006 that would have re-written the basic legal liability rule, but would not have required economic burden in order to claim a foreign tax credit.[337] Instead, those regulations essentially would have defined legal liability as belonging to the person who owns or is required to take into account (as determined under foreign law) the income that is subject to foreign tax. The Treasury and IRS did not finalize that portion of the proposed regulations when other parts of the regulation package were finalized in 2012, but stated at the time that they were still considering refinements to the basic legal liability rule, especially in the case of withholding taxes.[338] One major difficulty is that, if the Treasury and RS remove "legal liability" as the standard for which a person is eligible to claim a credit for particular taxes, it is not immediately clear how to craft a better standard. The legal liability rule has been a sore spot in the foreign tax credit rules for quite some time, though, and it may be time to revisit it.

---

334 *See supra* note 68 and accompanying text.

335 Salem I, 112 Fed. Cl. 543, 586 (2013) (emphasis added).

336 *See supra* Section II.D.a.

337 *See* Prop. Treas. Reg. § 1.901-2(f)(1) (proposed Oct. 13, 2006), https://www.irs.gov/irb/2006-36_IRB/ar12.html (last visited May 1, 2017).

338 T.D. 9576, 2012-1 C.B. 723. The Treasury and IRS also, in 2012, finalized some modifications to the legal liability rule for consolidated groups and for changes in ownership of disregarded entities and partnerships (and technical terminations of partnerships). *See* Treas. Reg. § 1.901-2(f)(3)–(4); *see generally* Rebecca Rosenberg, *New Regulations on Legal Liability*, 134 TAX NOTES 1291 (2012).

C. *Possible Guidance Under Section 7701(o)*

The Treasury and IRS could also issue guidance under section 7701(o) as to the application of the economic substance doctrine. For example, such guidance could require that foreign taxes are treated as a cost in computing profit. Congress specifically granted regulatory authority (a mandate, in fact) for Treasury to issue guidance that treats foreign taxes as a cost "in appropriate cases."[339] Courts have been conflicted on the treatment of foreign taxes in the economic substance analysis (as discussed above), and the IRS and Treasury could answer the question and provide direction.

So far, the IRS has issued two notices regarding section 7701(o), but neither notice provides a rule for determining when foreign taxes are treated as costs (or not) in computing profit.[340] One such notice says that the IRS will continue to follow pre-section-7701(o) case law regarding the meaning of the objective and subjective prongs, until further guidance is issued.[341]

Potentially, either the courts (through refinement of the economic substance doctrine) or Treasury (through guidance under section 7701(o)) could also provide that profit must reach at least a certain numeric ratio, compared to the expected U.S. tax benefit, in order to serve as a basis for meeting the objective prong of the economic substance test.[342] Section 7701(o)(2)(A) requires that such ratio must be "substantial" before profit can be taken into account under the objective and subjective prongs, but does not define "substantial" in numeric (or other) terms. In theory, Treasury and the IRS could issue guidance on what "substantial" means. For example, is 1:20 acceptable? Is 1:100 sufficient? And does the acceptable ratio (the definition of "substantial") vary for different tax benefits, based on the intent of the Congressional provisions that create such benefits? Guidance could also potentially provide standards for analyzing business purpose, including some definitional concepts.

D. *Possible New Approaches: Section 901(k)-like or FOGEI-like Provisions*

1. An Approach Similar to 901(k) and (l)

In theory, Congress could consider an approach similar to sections 901(k) and (l),[343] which make certain foreign income taxes deductible rather than creditable if such foreign taxes are described in the mechanical anti-abuse rules set forth in those sections. These sections disallow foreign tax

---

[339] *See* 26 U.S.C. § 7701(o)(2)(B) (2016).
[340] *See* I.R.S. Notice 2010-62, 2014-2 C.B. 746; I.R.S. Notice 2014-58, 2010-2 C.B. 411.
[341] *See* I.R.S. Notice 2010-62, 2010-2 C.B. 411.
[342] This leaves open the possibility that a change in economic circumstances—other than profit—could also meet the objective prong. *See id.* § 7701(o)(1)(A).
[343] *See* 26 U.S.C. §§ 901 (k), (l).

credits based on bright-line rules regarding holding periods and obligations to make related payments. Under those sections, such non-creditable foreign taxes are deductible despite the usual rules of section 275 (which generally prohibit deducting creditable foreign income taxes if the taxpayer is also claiming a foreign tax credit for any foreign taxes).[344]

If Congress applied a similar approach to transactions in which there appears to be too little profit compared to expected foreign tax credits, it could provide that foreign taxes are not creditable (but are deductible, despite section 275), if the ratio of reasonably expected profit to reasonably expected foreign tax credits is less than a defined amount (for example, less than 1:1, so that creditable foreign tax costs exceed expected incremental net income from a transaction).[345] Such a denial of credits may prevent the transaction from being viable for the U.S. taxpayer (even if deductions are allowed), thus deterring some transactions with insufficient non-tax substance. (For example, in the STARS cases, incremental income from the trust transaction was approximately half the foreign tax costs for the transaction. Using the *Salem* court's example numbers,[346] a deduction of approximately $7.70 (35% of $22 of foreign tax) per $100 of income (from the trust's assets) would not have been enough to induce a transaction with a predicted cost of approximately $11 per each such $100 of income.) In other words, despite taxpayers' claims that foreign taxes are not a cost for economic substance test purposes, foreign taxes equal to or in excess of profit may be enough of an economic cost to deter the transaction if only deductions (and not credits) for foreign taxes are allowed for U.S. tax purposes.

One advantage of such a rule is that it could provide a clearer standard and thus could be easier for the IRS and taxpayers to apply, compared to the gray area, facts-and-circumstances application of the economic substance doctrine. Challenges would include defining the appropriate ratio and determining the parameters of the transaction to be tested.[347]

2. A FOGEI-Type Rule

Alternatively, Congress could consider a rule that, like the Foreign Oil and Gas Extraction Income (FOGEI) provisions of the Code, disallows part but not all of the foreign tax credits claimed in particular circumstances.[348] The FOGEI rules limit the credit for FOGEI taxes to the product of relevant income multiplied by (for a corporation) the highest U.S.

---

[344] *See id.* §§ 901(k)(7), 901(l)(4), 275.

[345] *Cf.* Notice 98-5, withdrawn (predicting the issuance of regulations that would use a ratio (of reasonably expected profit to expected foreign tax credits) to disallow foreign tax credits from certain types of transactions).

[346] *See supra* note 55 and accompanying text.

[347] *Cf. supra* Section III.B (discussing the determination of what arrangement is to be tested under the economic substance doctrine).

[348] *See* 26 U.S.C. § 907 (2016).

corporate tax rate listed in section 11. Foreign taxes made non-creditable by these FOGEI rules may be carried back one year or forward ten years, although they face the same limitation (the credit is limited to relevant income multiplied by the highest U.S. corporate rate) in the year to which they are carried.[349]

A similarly structured rule, for situations in which foreign taxes seem excessive in relation to expected profit from the transaction, could provide that if the reasonably expected profit-to-credit ratio for a transaction is less than a stated ratio (perhaps 1:1), then foreign tax credits for incremental foreign taxes caused by the transaction are limited to the product of the U.S.-perceived net income (reasonably expected) from such transaction multiplied by the highest U.S. tax rate under section 11 (for corporations, and perhaps section 1 for individuals).[350] Such a rule has the advantage of not disallowing all of the foreign tax credit (thus ameliorating double taxation on the U.S.-perceived incremental profit from the transaction). (The economic substance doctrine, in contrast, disallows all of the tax effects of an economic sham.) As with a section 901(k)-like approach, pressure points would include defining the relevant transaction and the profit-to-credit ratio that is used as a standard.

V. SUMMARY: HOW THE ECONOMIC SUBSTANCE DOCTRINE IDEALLY SHOULD BE APPLIED TO THE STARS CASES, AND WHAT THOSE CASES PORTEND

To summarize the discussion above, the application of the economic substance doctrine to the STARS fact pattern should have concluded that such transactions failed the objective prong due to lack of profit potential and lack of change in economic position. Foreign taxes should have been treated as a cost in computing reasonably expected profit for these purposes. The STARS opinions other than *Santander I* (and *Wells Fargo*, where the jury's treatment of the foreign taxes is not completely clear) did indeed take that approach, leading to a finding that the STARS trust transaction failed the objective portion of the test. The transactions also lack business purpose, because they had no apparent motive (and nothing to gain) other than the potential foreign tax credit. Further, the STARS transactions violate the fundamental policy of the foreign tax credit: the credit was intended to decrease foreign taxes' impact on business decisions of U.S. taxpayers, but the credit in the STARS cases instead caused transactions that (apart from the foreign tax credit) were completely pointless for the U.S taxpayer. Without the foreign tax credit, the U.S. banks in STARS suffered a loss from their participation, because the Bx payment (their service fee) was only around half of their foreign tax costs.

The STARS cases do not devote much time to the preliminary issue

[349] *Id.* § 907(f).
[350] *Cf. id.* § 907(a)(2)(B) (providing a more complex multiplier for individuals).

of whether the economic substance doctrine should apply to foreign tax credits at all, given Congress's many policy compromises in this area. All of those compromises arguably were only intended to apply to actual business transactions (with reasonably expected profit or economic impact, and business purpose). It would be helpful (as a precedent regarding the application of the economic substance doctrine in general) to see more courts explicitly analyze the difficulties of this issue.

For the future, the STARS cases have created a split between the circuits regarding whether foreign taxes are a cost for purposes of the profit computation under the economic substance doctrine. In doing so, they have revived the economic substance doctrine as a potential weapon for the government in foreign tax credit cases. Until the STARS cases, the only appellate court opinions on this topic held that foreign taxes are not a cost for these purposes,[351] which made it much harder for the government to challenge foreign tax credit claims using economic substance arguments. Economic substance is an appropriate weapon to address the STARS cases, and the profit analysis element of the economic substance doctrine applies smoothly if foreign taxes are treated as a cost.

Because of the circuit split on the foreign-taxes-as-costs issue, there may be increased emphasis in the future on the business purpose prong. After section 7701(o), the government only needs to win one prong (objective or subjective) to prevail, so business purpose is an attractive alternative to a possibly contentious argument about the profit computation (in circuits other than those that decided the STARS cases). We can also expect more weight on the business purpose analysis in the future because section 7701(o) requires the conjunctive approach and because it can be read as preventing business purpose from being merely a repetition of the objective prong. Business purpose has historically been given less prominence than the objective prong, and currently lacks much clear guidance about how to define it.

The STARS opinions, overall, show the government and the courts struggling to articulate (in the absence of any specifically applicable statutory or regulatory rule) why these transactions are offensive when other foreign tax credit claims (also problematic from a policy perspective) are allowed. Not all of the troubling elements of the STARS transactions fall neatly within the parameters of the economic substance analysis.

The STARS cases are a nice illustration of the difficulties of fitting the all-purpose, one-size-fits-all economic substance doctrine to complex facts and a very detailed set of legislative and regulatory rules, and of the countervailing benefit of having this emergency backup weapon available

[351] *See* Compaq, 277 F.3d 778, 788 (5th Cir. 2001); IES, 253 F.3d 350, 353–56 (8th Cir. 2001).

when there are few other options for challenging a tax benefit that violates the purpose of its statute. The economic substance doctrine, in the STARS cases, did exactly what it was created to do: although it was not a perfect fit, and contained some gray areas, it provided a backup means to address unintended tax benefits.

But the bigger point of the STARS cases is that they leave uncertainty regarding the application of the economic substance doctrine to foreign tax credit cases, largely because some circuits may choose not to treat foreign taxes as costs for such purposes. The *Wells Fargo* case, for example, might ultimately be decided in favor of the STARS transaction on appeal. Therefore, the STARS cases highlight the need for an alternative approach to address arguably abusive foreign tax credit claims: either a focus on the business purpose prong of the economic substance test (especially after the effective date of section 7701(o)) or a different approach than economic substance, such as a subsidy argument.

APPENDIX: ABBREVIATED SUMMARY OF STARS DECISIONS

Opinion	Holding generally	Holding-foreign tax credit	Holding-interest	Are Foreign taxes a cost?	Is the Bx payment income?	Business purpose?
Bank of N.Y. Mellon Corp. v. Comm'r, 801 F.3d 104 (2d Cir. 2015) (*BNY Mellon II*), *cert. denied sub nom.*, 136 S.Ct. 1375 (2016)	Economic sham	No foreign tax credit	Interest is separable and respected	Yes, foreign taxes are a cost	No, Bx payment is not income – Tax Court did not err, but there is no profit either way	Not for trust, yes for loan
Bank of New York Mellon Corp. v. Commissioner, 140 T.C. 15 (2013) (*BNY Mellon I*), *modified*, 106 T.C.M. (CCH) 367 (2013), *aff'd*, *BNY Mellon II*	Economic sham	No foreign tax credit	Originally: no interest deduction On reconsider ation: interest is separable and respected	Yes, foreign taxes are a cost – in cases not appealable to the 5th or 8th Circuit	No, Bx payment is not income	Not for trust, yes for loan (after rehearing)
Salem Fin., Inc. v. United States, 786 F.3d 932 (Fed. Cir. 2015) (*Salem II*), *cert. denied*, 136 S.Ct. 1375 (2016)	Economic sham	No foreign tax credit	Interest is separable and respected	Yes, foreign taxes are a cost	Yes, Bx payment is income	Not for trust, yes for loan
Salem Financial, Inc. v. U.S., 112 Fed. Cl. 543 (2013) (*Salem I*), *reconsid. denied*, Salem Fin., Inc. v. United States, 119 Fed. Cl. 84 (2014), *aff'd in part, rev'd in part*, *Salem II*	Economic sham	No foreign tax credit	No interest deduction	Does not discuss this issue	No, Bx payment is not income	No business purpose
Santander Holdings USA, Inc. v. United States, 844 F.3d	Economic sham	No foreign tax credit	Not addressed - Governme nt did not	Yes, foreign taxes are a cost	Does not address this issue	No business purpose

Opinion	Holding generally	Holding-foreign tax credit	Holding-interest	Are Foreign taxes a cost?	Is the Bx payment income?	Business purpose?
15 (1st Cir. 2016) (*Santander III*), *cert. denied*, 137 S.Ct. 2295 (2017)			pursue arguments regarding interest, interest respected under lower court decision			
Santander Holdings USA, Inc. v. United States, 144 F. Supp. 3d 239 (D. Mass. 2015) (*Santander II*), Santander Holdings USA, Inc. v. United States, 977 F. Supp. 2d 46 (D. Mass. 2013) (*Santander I*), *rev'd*, *Santander III*	Not an economic sham	Foreign tax credit respected	Interest respected	No, foreign taxes are not a cost	Yes, Bx payment is income	Yes
Wells Fargo & Co. v. United States, No. 09-CV-2764, 2017 U.S. Dist. LEXIS 80401, 2017-1 U.S. Tax Cas. (CCH) P50,235 (D. MN. May 24, 2017) (*Wells Fargo II*), appeal docketed, No. 17-3578, No. 17-3676 (8th Cir. November 24, 2017)	Economic sham	No foreign tax credit under jury's verdict	Interest separable and respected	Not addressed in this opinion	No, Bx payment is not income	No
Wells Fargo & Co. v. United	Economic sham	No foreign tax credit	The court requested	Motion to treat	Court denied	No business

Opinion	Holding generally	Holding-foreign tax credit	Holding-interest	Are Foreign taxes a cost?	Is the Bx payment income?	Business purpose?
States, 143 F. Supp. 3d 827 (D. Minn. 2015) (*Wells Fargo I*)		under jury's verdict	further briefing regarding the loan	foreign taxes as not a cost denied, *see* 2011 U.S. Dist. Lexis 127976	motion to treat the Bx payments as income, leaving the issue to the jury	purpose, according to the jury