DELINEATING PERMISSIBLE TAX PLANNING AND ABUSIVE TAX AVOIDANCE: TAX SHELTERS, PRE-TAX PROFIT, AND THE FOREIGN TAX CREDIT

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ABSTRACT

This Note will argue that the United States Supreme Court should resolve the heavily contested issue of whether taxes paid out to foreign governments should be included as expenses when calculating pre-tax profit for the purposes of applying the economic substance doctrine to transactions that allow American taxpayers to claim foreign tax credits on their domestic tax returns. This Note will argue further that the Supreme Court should resolve the above issue by implementing the logic prescribed by the U.S. Courts of Appeals for the First, Second, and Federal Circuits, which have held that taxes paid to foreign governments as a result of taxpayer participation in cross-border transactions that aim to produce foreign tax credits should be counted as expenses when calculating such transactions' pre-tax profit potential.[1] *Their holdings were based on the premise that taxes paid as a result of the transaction are economic costs that taxpayers take into account when deciding whether to participate in transactions of this nature.*[2] *In arguing that the Supreme Court should follow this line of cases, this Note will consider the decisions regarding this issue that have come out of the Federal, First, Second, Fifth, and Eighth Circuit Courts of Appeals. The Federal, First, and Second Circuits considered the issue in the context of the STARS tax sheltering transaction, which has been implemented by several big-name corporate taxpayers within the last decade.*[3] *The Fifth and Eighth Circuits considered the same issue, but in the context of the ADR tax shelter transaction, which was more commonly executed in the 1990's.*[4]

I. AN INTRODUCTION TO TAX PLANNING AND TAX AVOIDANCE

In the 1934 landmark case of *Helvering v. Gregory*, Judge Learned Hand infamously proclaimed that "[a]ny one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes."[5] The tax planning industry has since interpreted this statement to be

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[1] *See* Santander Holdings USA v. United States, 844 F.3d 15, 24 (1st Cir. 2016); Bank of N.Y. Mellon Corp. v. Comm'r, 801 F.3d 104, 118 (2d Cir. 2015).

[2] *See Bank of N.Y. Mellon Corp.*, 801 F.3d at 105; Salem Fin, Inc. v. United States, 786 F.3d 932, 936, 948 (Fed. Cir. 2015).

[3] *See Salem Fin.*, 786 F.3d at 932; *Bank of N.Y. Mellon Corp.*, 801 F.3d at 104; *Santander Holdings USA*, 844 F.3d at 15.

[4] *See* Compaq Computer Corp. v. Comm'r, 277 F.3d 778, 778 (5th Cir. 2002); IES Indus. v. United States, 253 F.3d 350, 350 (8th Cir. 2001).

[5] Helvering v. Gregory, 69 F.2d 809, 810 (2d Cir. 1934), *aff'd,* 293 U.S. 469 (1935). While *Gregory* may be cited for Judge Learned Hand's tax planning endorsement, it should

a veritable green light regarding the bulk of its activity.[6] The pro-tax avoidance rhetoric that Judge Hand provided in *Gregory* gave the industry a powerful endorsement in its efforts to "legitimize and mainstream its activities."[7] Accordingly, the tax planning industry has experienced tremendous growth since 1934.[8]

In general, tax planners work to minimize the net amount of tax that their clients must pay to the government. Tax planners "add value" for their clients by pinpointing and helping to execute transactional structures "consistent with the[ir] clients' business or investment objectives" that also produce "more favorable tax outcome[s] than other possible structures."[9] The goal of tax planning clients, by and large, is to structure their financial affairs in such a way that they owe as little tax as possible at the close of the taxable year, without crossing the line into impermissible tax avoidance[10] or tax evasion.[11]

be noted that the Supreme Court ultimately affirmed judgment in favor of the government, upholding the Commissioner's assessment of a deficiency where taxpayer's new corporation, formed pursuant to a tax-motivated reorganization, was found to be "nothing more than a contrivance." *Id.* at 469-70.

6 *See* Henry Ordower, *The Culture of Tax Avoidance*, 55 ST. LOUIS U. L.J. 47, 47 (2010).

7 *Id.*

8 *See generally* Arthur P. Hall, *Growth of Federal Government Tax "Industry" Parallels Growth of Federal Tax Code*, 39 TAX FOUND. SPECIAL REP. 1, 1 (1994) (discussing the steady growth of the United States federal tax code and the corresponding growth of the tax planning industry).

9 Ordower, *supra* note 6, at 47.

10 Jasmine M. Fisher, *Fairer Shores: Tax Havens, Tax Avoidance, and Corporate Social Responsibility*, 94 B.U. L. REV. 337, 340 (2014) ("[T]ax avoidance practices seek to accomplish one of three things: payment of 'less tax than might be required by a reasonable interpretation of a country's law,' payment of a tax on 'profits declared in a country other than where they were really earned,' or tax payment that occurs 'somewhat later than the profits were earned.' Individuals who engage in tax avoidance often rely on doubt surrounding the applicable tax laws, as well as tax professionals who wish to exploit this uncertainty.") (citing RONEN PALAN ET AL., TAX HAVENS: HOW GLOBALIZATION REALLY WORKS 10 (2010); Boris I. Bittker, *Income Tax "Loopholes" and Political Rhetoric*, 71 MICH. L. REV. 1099, 1102 (1973) ("In popular mythology, indeed, the major activity of tax experts is the search for divergencies [sic] between the letter of the law and its spirit . . . .")).

11 *See generally* Ordower, *supra* note 6; Fisher, *supra* note 10, at 339-40 ("'[T]ax evasion' typically refers to illegally reducing tax payments, while 'tax avoidance' generally refers to legally reducing tax payments . . . . [T]ax evasion' refers to conduct involving some level of 'deception, concealment, [or] destruction or records,' whereas 'tax avoidance' refers to 'behavior that the taxpayer hopes will serve to reduce his tax liability but that he is prepared to disclose fully to the IRS.'") (citing RONEN PALAN ET AL., TAX HAVENS: HOW GLOBALIZATION REALLY WORKS 9-10 (2010); NIGEL FEETHAM, TAX ARBITRAGE: THE TRAWLING OF THE INTERNATIONAL TAX SYSTEM 2 (2011); John Hasseldine & Gregory Morris, *Corporate Social Responsibility and Tax Avoidance: A Comment and Reflection*, 37 ACCT. F. 1, 6 (2013); BORIS I. BITTKER & MARTIN J. MCMAHON, JR., FEDERAL INCOME TAXATION OF INDIVIDUALS ¶ 1.3[2] (2d ed. 1995)).

If the credits and deductions that are ordinarily available to taxpayers do not sufficiently reduce the taxpayers' tax bills, tax planners may be tempted to suggest that the taxpayers take a more aggressive approach to tax mitigation in order to justify their fees. In the case of large corporate clients or high-earning individual taxpayers, tax planners often try to find creative solutions in order to substantially reduce their clients' effective income tax rates.[12]

Two examples of such approaches that tax planners have promoted to their clients are the American Depositary Receipts ("ADR") transaction and the Structured Trust Advantaged Repackaged Securities ("STARS") transaction. The ADR transaction is an income tax-lowering mechanism that generates foreign tax credits through the purchase and resale of shares in a foreign corporation.[13] The STARS transaction also creates foreign tax credits for a United States-based client, but does so by "circulating U.S. income through a [foreign] entity, usually a trust,"[14] while also producing tax advantages for a participating foreign institution. These two transactions differ in complexity and form, but their goals and end results are the same. Upon completion of each transaction, the participating taxpayer can use the foreign tax credits generated to offset its U.S. federal income tax liability.[15]

While some "creative" solutions are widely accepted by courts as legitimate vehicles for minimizing taxpayers' income tax burdens,[16] more aggressive solutions, like the ADR and STARS transactions, can attract unwanted attention from the Internal Revenue Service ("IRS"). In the tax planning industry, an "aggressive" approach is one that involves crafting special transactions that do not violate the black letter rules set out in the

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[12] *See, e.g.*, *Santander Holdings USA*, 844 F.3d at 15 (following the Second and Federal circuits in disallowing tax credits claimed as a result of the STARS transaction); *Salem Fin.*, 786 F.3d at 932 (disallowing tax credits claimed by taxpayer through use of a tax shelter); *Bank of N.Y. Mellon Corp*., 801 F.3d at 110 (discussing the taxpayer's use of a tax shelter dubbed the "STARS transaction," created jointly by an accounting firm and bank); *IES Indus*., 253 F.3d at 350 (allowing the credits claimed from the taxpayer's use of the "ADR transaction" tax shelter); *Compaq Computer Corp.*, 277 F.3d at 778-79 (permitting the foreign tax credits claimed by taxpayer via use of a tax shelter).

[13] *See* Jeremy H. Temkin, *The Economic Substance of Foreign Tax Credits*, 254 N.Y. L. J. 1, 2 (2015).

[14] Stanley C. Ruchelman & Christine Long, *S.T.A.R.S. Transactions - Interest Deduction Allowed but Foreign Tax Credit Disallowed*, 2 RUCHELMAN P.L.L.C. INSIGHTS 28, 28 (2015).

[15] *See generally* Temkin, *supra* note 13 (outlining the structures and outcomes of the STARS and ADR tax shelters).

[16] In *Frank Lyon Co. v. United States*, the court upheld deductions resulting from a sale-and-leaseback transaction. 435 U.S. 561, 583-84 (1978). The court explained that, "where . . . there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached, the Government should honor the allocation of rights a duties effectuated by the parties." *Id.*

Internal Revenue Code (the "Code"), but may not have sufficient economic reasoning to support them as legitimate transactions.[17] Conversely, a "legitimate" transaction is one that is entered into for business reasons not entirely related to its tax effects. The more aggressive an approach the tax planner (and the client) takes, the more likely it is that the IRS will audit the taxpayer's return, and disallow the credits or deductions that the transactions in question were intended to generate.[18]

By nature of their industry, tax planners walk the line that divides permissible "tax planning" and impermissible "tax avoidance."[19] Precisely where this line stands at any given moment in relation to a contemplated transaction is essential knowledge for tax planners and, ultimately, for their clients. A determination by the Commissioner of the IRS or by any U.S. court of law on matters of tax avoidance versus tax planning could make the difference between a manageable tax bill and an unexpected, and presumably unwanted, debt to the federal government.

Aggressive tax-planning mechanisms (or "tax shelters") frequently draw the attention of the IRS because the federal income tax law has developed in such a way that there is often a disconnect between the letter of the law and the interpretation of taxing statutes by the IRS or the courts.[20] While tax planners who implement these aggressive strategies may assure their clients that they are following the law, this disconnect presents a risk that the client will, despite its participation in the aggressive tax planning transaction, have

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[17] *See* Peter L. Faber, *Evaluating Aggressive Tax Strategies: A Methodology in Light of New Court Cases*, PHILA. BAR ASS'N (Dec. 6, 2000), http://www.philadelphiabar.org/page/TSAggressiveStrategies?appNum=1 ("Many of the 'products' are extremely aggressive and involve attempts to use provisions of the laws and administrative regulations to achieve results that the drafters did not contemplate and would not have allowed if they had thought about them.").

[18] *See, e.g.*, IRM 4.71.26.6 (May 10, 2016) ("An abusive tax avoidance transaction includes the organization or sale of any . . . actions to impede the proper administration of Internal Revenue laws . . . . This general definition includes both tax shelters as defined in various sections of the IRC and other types of abusive tax promotions . . . . The IRS is engaged in extensive efforts to curb [Abusive Tax Avoidance Transactions & Technical Issues] schemes [and] devote[s] resources to identifying, analyzing and examining abusive tax shelter schemes and promotions"). *But see* LEANDRA LEDERMAN & STEPHEN W. MAZZA, TAX CONTROVERSIES: PRACTICE AND PROCEDURE 91-92 (3d ed. 2009) (discussing selection of returns for audit and explaining that the DIF score used in classifying returns is based on a top-secret formula that gives weight to certain unknown return characteristics, but that the IRS also has other methods of selecting tax returns for audit) (citing I.R.C. § 6103(b)(2) (2006)).

[19] *See generally* Ordower, *supra* note 6 (discussing the history and nature of the tax planning industry in the United States as it relates to its strong tendency toward the promotion of tax avoidance).

[20] *See* Ordower, *supra* note 6, at 50 ("Judge Hand . . . sought to limit tax-reducing arrangements to those that are consistent with the *intention* of the taxing statute.") (emphasis added).

to pay the full amount of the tax. This would be the case if the IRS or a court disallowed any claimed tax advantages resulting from the transaction for any number of reasons, including, for example, the transaction's failure to meet the standards for economic substance.[21] One result of the overall uncertainty in tax law with respect to the treatment of novel transactions is that tax planners can have a difficult time determining how far they can push the "letter of the law" before the taxing authorities decide to step in.

Consider the effects that such uncertainty might have on taxpayers, on whom the burden of this lack of clarity will, in most cases, ultimately fall. There is a certain sense of confidence among those less risk-averse taxpayers that they will not get caught participating in a questionable tax sheltering transaction.[22] Perhaps this confidence stems from the widespread knowledge that the chances of any single taxpayer actually losing the audit lottery are quite slim.[23] On audit, the IRS generally only assesses deficiencies for voided deductions or credits that the taxpayer would have had to pay regardless,[24] and so some taxpayers may be tempted to engage in aggressive tax planning strategies simply because they do not believe they have anything to lose. However, in addition to the possibility of court invalidation of deductions or credits taken, there is a certain amount of risk that accompanies participation in aggressive tax shelters. There are at least three foreseeable risks of participating in aggressive tax shelters like the ADR or STARS transaction.

First, there is a risk that the use of one tax shelter produces a worse ultimate tax outcome than the next safer alternative. Although any further analysis of this risk must be largely based on hindsight, tax planners and their clients

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[21] *See, e.g.*, *Santander Holdings USA*, 844 F.3d at 26 (disallowing foreign tax credits claimed as a result of the STARS transaction); *Bank of N.Y. Mellon Corp.*, 801 F.3d at 107 (disallowing the foreign tax credits received from taxpayer's use of the STARS transaction tax shelter and ordering the taxpayer to pay the deficiency that resulted from the court's disregard of the shelter); *Salem Fin.*, 786 F.3d at 932 (disallowing tax credits claimed by taxpayer through use of a tax shelter lacking economic substance).

[22] *See, e.g.*, Robert W. Wood, *IRS Admits Audit Chance is Small—and Dropping Like a Rock*, FORBES (Mar. 28, 2016, 8:40 AM), https://www.forbes.com/sites/robertwood/2016/03/28/irs-admits-audit-chance-is-small-and-dropping-like-a-rock/#626dc8a322f9 [https://perma.cc/2QW9-P87U] ("IRS audits of individuals dropped to an 11-year low . . . ma[king] many taxpayers happy who, understandably, do not want to be audited . . . . [In 2016, t]he IRS is auditing only 0.84% of individual taxpayers, less than 1 in 100.").

[23] INTERNAL REVENUE SERV. [IRS], 2015 DATA BOOK 21 (2015), https://www.irs.gov/pub/irs-soi/15databk.pdf [https://perma.cc/4THG-2ESM] ("The IRS audited a total of almost 1.4 million tax returns, approximately 0.7 percent of all returns filed in Calendar Year (CY) 2014 . . . [and] audited 0.8 percent of all individual income tax returns filed in CY 2014, and 1.3 percent of corporation income tax returns (excluding S corporation returns).").

[24] Heads the taxpayer wins; tails the taxpayer does not lose, so to speak.

should, to the best of their abilities, take this risk into consideration before participating in any transaction that could be construed as carrying tax-sheltering characteristics. In this sense, it is simply good business practice to consider the full spectrum of risks associated with participation (or lack thereof) in any transaction. If the taxpayer could have used another, safer tax sheltering transaction that may have netted less overall pre-audit tax savings, but that is also less likely to be struck down if audited, which is the better alternative? Despite the fact that competent tax planners warn their clients about the realities of this risk,[25] a client who has to pay a hefty sum to the government post-audit is not likely be happy with the tax planner.[26] Tax planners can minimize this risk if they are clear on what legally constitutes a slightly-too-aggressive tax shelter. The problem is that, particularly with transactions that implicate the foreign tax credit, like STARS or ADR, there is a great deal of grey area that remains in the doctrine.

The second risk that should be taken into consideration is the danger of penalties, which the IRS can impose on taxpayers who underpay their taxes or underreport their income for the taxable year.[27] When the IRS determines that a transaction the taxpayer used (e.g. a tax shelter) is not permitted by tax law and subsequently disallows it, the taxpayer will be vulnerable to penalties due to underpayment. That is, if the IRS or the court has rejected a transaction that was used to avoid taxes, the resulting tax owed could evince the "underpayment" or "underreporting" element that is necessary for the IRS to impose penalties on the taxpayer. Section 6662(b)(6) of the Code is

[25] *But see, e.g.*, *When Tax Avoidance Crosses a Line*, NEWSWEEK (Apr. 10, 2007, 8:00 PM), http://www.newsweek.com/when-tax-avoidance-crosses-line-97895 ("[L]aw firms, such as Sidley Austin Brown & Wood LLP, issued form letters saying the [tax] shelters were 'more likely than not' legitimate, giving their clients the illusion that they were shielded from potential IRS penalties.").

[26] *See id.* ("[F]irms [that marketed aggressive tax shelters] were forced to disclose their clients' names, and the IRS went after those clients for back taxes and penalties, resulting in the clients suing [the] firms.").

[27] *See* I.R.C. § 6662 (2012) (imposing a 20 percent accuracy-related penalty on any portion of an underpayment of tax to which certain listed characteristics apply, and increasing the penalty to 40 percent where the underpayment is attributable to a gross misstatement of value); I.R.C. § 6700 (2012) (permitting imposition of penalties on those who promote abusive tax shelters); *see, e.g.*, *Bank of N.Y. Mellon Corp.*, 801 F.3d at 109 ("[T]he Internal Revenue Service (the "IRS") sent AIG a Statutory Notice of Deficiency for its 1997-1999 taxes. For the 1997 taxable year, the notice claimed an additional income tax of $110.2 million, and interest, penalties, or additions to tax of $12.6 million. Among other penalties and assessments, the IRS disallowed the $48.2 million in foreign tax credits AIG claimed in 1997."). *See also Regulations on Abusive Tax Shelters and Transactions,* IRS (Aug. 26, 2017), https://www.irs.gov/businesses/corporations/regulations-on-abusive-tax-shelters-and-transactions [https://perma.cc/33VF-MF36] (listing other penalties available that are associated with reportable transactions).

especially relevant to the discussion of the risks inherent in aggressive tax shelters. This provision imposes an automatic penalty equal to twenty percent of the amount underpaid when a tax benefit is disallowed because the transaction producing the benefit lacked economic substance within the meaning of Section 7701(o) of the Code.[28] This should give tax planners and their clients pause when contemplating the use of a tax shelter because the IRS frequently disallows such transactions on grounds that they lack economic substance.[29]

Finally, there is the slightly more remote risk that participants in an aggressive tax shelter could face criminal charges for tax evasion or tax fraud. In a worst-case scenario, the IRS or court may determine that a certain transaction designed to avoid paying tax amounts to an "abusive tax shelter."[30] An abusive tax shelter is a highly aggressive tax avoidance scheme that can, in certain cases, amount to tax evasion leading to civil and criminal penalties for taxpayers and tax professionals alike.[31]

These risks, in addition to the uncertainty that already surrounds the use of aggressive tax shelters, can result in a gamble that informed and conscientious clients might be unwilling to take. Therefore, tax planners must focus a great deal of their efforts on finding the answer to the ever-looming question: where is the legal line?

In arguing that the Supreme Court should answer this question, we must choose a legal and transactional context from which we can branch out our

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[28] I.R.C. § 6662(b)(6) (2012).

[29] Joseph Bankman, *The Economic Substance Doctrine*, 74 S. CAL. L. REV. 5, 5-6 (2000) ("For more than fifty years, courts have interpreted and applied the tax law with the aid of various 'common law' doctrines, such as substance over form, step transaction, business purpose, sham transaction, and economic substance . . . . The recent phenomenon of corporate tax shelters has produced a resurgence in the use of common law doctrines . . . [and] the economic substance doctrine has played a particularly important role in the government's fight against corporate tax shelters.")

[30] *See, e.g.*, *Briefing Book: A Citizen's Guide to the Fascinating (Though Often Complex) Elements of the Federal Tax System,* THE TAX POL'Y CTR., http://www.taxpolicycenter.org/briefing-book/what-tax-shelter (last visited Oct. 1, 2017) (explaining that "abusive" tax shelters, distinct from other tax avoidance strategies, may constitute tax evasion).

[31] *See, e.g.*, Howard Gleckman, Amy Borrus & Mike McNamee, *Inside the KPMG Mess: Why Eight Partners May be Facing Jail Time—and What the Suit Could Mean for the Tax-Shelter Business,* BUSINESSWEEK, Sept. 12, 2005, at 46-47 (reporting on a potential $465 million fine for KPMG partners who allegedly committed tax-shelter fraud, noting that the marketing of tax shelters may wane so that tax professionals can avoid jail time and lawsuits by clients that must pay back taxes and penalties); *see also* THE TAX POL'Y CTR., *supra* note 30 ("The Internal Revenue Service makes a distinction between tax sheltering (which encompasses legal forms of reducing tax liability . . .) and "abusive" tax sheltering (i.e. tax evasion, which is illegal). One example of an abusive tax-sheltering scheme is the use of trusts to reduce tax liability by over-claiming deductions or even by hiding assets from taxation.").

inquiry. This Note will consider the question from the legal perspective of a recurring income tax sheltering issue that has yet to be resolved. The issue is whether, for the purposes of applying the economic substance doctrine to a foreign tax credit-producing transaction, the courts should include as expenses any foreign taxes paid out when calculating the pre-tax profit potential of such transaction. To provide transactional perspective, this Note will consider the issue as applied by five separate Circuits to the ADR and STARS tax shelters, the main purposes of which were to generate foreign tax credits.

In order to properly analyze this issue, it is important to first lay out the general landscape of relevant U.S. federal income tax law. To do so, this Note will consider the relationship between the relevant aspects of the ADR and STARS tax shelter transactions and the U.S.'s anti-tax avoidance doctrine. The doctrine has steadily grown and shifted alongside the tax planning industry to produce a common law and statutory scheme that focuses heavily on economic substance. For the purposes of this Note, the most important aspect of these tax shelters is the foreign tax credits that they generate, especially as they relate to foreign taxes paid and the economic substance of those payments. In order to assess the economic substance (or lack thereof) of the STARS and ADR foreign tax credits, this Note will first discuss the structure of the transactions, followed by the history and doctrine of U.S. anti-avoidance tax law.

II. STARS AND ADRS

A. *The Structure of the STARS Transaction*

In December 2016, the First Circuit reversed the decision of the lower court on appeal in *Santander Holdings USA v. United States*, ultimately finding in favor of the government regarding a tax avoidance issue that has recently been cropping up in the banking business.[32] *Santander* is the most current in a line of cases dealing with the issue of whether foreign taxes paid as a result of the STARS transaction should be deductible in calculating pre-tax profit for the purposes of the economic substance doctrine.[33]

The STARS transaction was marketed to companies, usually banks, as a product that could substantially reduce a taxpayer's effective tax rate.[34]

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[32] *See Santander Holdings USA*, 844 F.3d at 26; *see also* Temkin, *supra* note 13, at 1 (discussing the Federal, Second, Fifth, and Eighth Circuit cases' treatment of the economic substance doctrine as applied to the foreign tax credits generated by the STARS and ADR transactions).

[33] *See generally* Temkin, *supra* note 13, at 1-2.

[34] *See id.* at 1 ("[A] loan product known as the 'Structured Trust Advantaged Repackaging [*sic*] Securities' (STARS) [has] been marketed by Barclays Bank, PLC and

Fundamentally, the STARS transaction consists of (1) a trust funded with a domestic bank's income-producing assets, and (2) a loan to the trust provided by a foreign bank.[35] In exchange for funding the trust, the domestic bank would receive shares in the trust.[36] The domestic bank would then appoint a foreign citizen as trustee so that the trust would pay foreign taxes.[37] The foreign bank would then purchase shares in the trust, for which the domestic bank would reimburse the foreign bank at the end of a predetermined period.[38]

The trust would then make monthly income distributions "using a circular multistep process."[39] The domestic taxpayer ultimately creates a tax shelter through the STARS transaction by (1) investing the loaned trust capital to earn income, which creates an obligation to pay foreign taxes that allows the domestic taxpayer to claim foreign tax credits, (2) paying dividends to the foreign bank, which allows the domestic taxpayer to deduct the value of the dividends as an interest expense, and (3) permitting the foreign bank to claim the dividend income as "tax-exempt dividends," which allows the foreign bank to share the tax benefits with the domestic taxpayer by "accepting a lower dividend rate than it would have otherwise demanded."[40] This series of steps reduces the domestic taxpayer's tax liability by "effectively convert[ing] certain interest expenses it otherwise would have paid to the foreign banks into foreign tax payments for which it claimed foreign tax credits that it could use in turn to offset unrelated income. . . ."[41]

The Second Circuit illustrated the operation of the STARS transaction as a tax shelter by "tracing a hypothetical $100 of trust income through the

KPMG.").

[35] *See* Christopher J. Lubrano, *Tax Law - Second Circuit Accurately Applies the Economic Substance Doctrine to Foreign Tax Credits - Bank of New York Mellon Corp. v. C.I.R., 801 F.3d 104 (2d Cir. 2015)*, 39 SUFFOLK TRANSNAT'L L. REV. 537, 539 n.15 (2016).

[36] *Id.* at 539.

[37] *Id.*

[38] *Id.* The net effect of this transaction is that a foreign bank provides a loan to the trust.

[39] *Id.* at 539-40.

[40] *See Bank of N.Y. Mellon Corp.*, 801 F.3d at 108-09 (2d Cir. 2015) (explaining that AIG was able to report total gross income from the transaction of $128.2 million, from which it could deduct $17.9 million in interest expenses, resulting in net taxable income of $56.3 million. Based on U.S. tax rate of 35%, AIG owed $19.7 million in U.S. taxes, but AIG could also claim $48.2 million in foreign tax credits, which were used to offset U.S. tax on its $19.7 million bill resulting from the transaction, as well as on $28.5 million in unrelated income while, at the same time, the foreign bank could report to its national revenue authority that it owned the SPV shares as an equity investment and, as a result, the SPV could be treated as a subsidiary of the foreign bank, meaning that the foreign bank could claim the dividends as tax-exempt).

[41] *Id.* at 109.

distribution cycle."[42] Based on that example, STARS transaction takes the form of a tax shelter in the following way: Barclays PLC, the relevant foreign bank in the transaction at issue, was deemed under United Kingdom ("U.K") law to be the owner of income generated from the trust, and was therefore obligated "to pay $30 in tax for every $100 of trust income," based on the 30% U.K. corporate tax rate.[43] However, Barclays claimed a "credit for the 22% U.K. tax on the trust" paid by Bank of New York Mellon ("BNY"), the U.S. based participant and taxpayer, reducing Barclays' tax on the trust income to $8 for every $100 of income generated.[44] Next, BNY could claim a foreign tax credit on its U.S. tax return because it paid the $22 U.K. tax on trust income.[45] Then, the parties participated in income distribution whereby, on a monthly basis, "for every $100 of trust income, the trust would set aside $22 to pay U.K. taxes, with $78 remaining for distribution."[46] This $78 was circulated through a blocked account and then transferred back to the trust.[47] Such circulation allowed Barclays to treat the $78 as a U.K. tax "trading loss deduction," meaning that, at a U.K. corporate tax rate of 30%, Barclays would receive a $23.40 U.K. tax deduction that could "more than offset Barclay's [*sic*] $8 tax bill from the trust, resulting in a net tax benefit to Barclays of $15.40."[48] The next step was for Barclays to "pay the $11 tax-spread to BNY," representing one-half of the trust's U.K. tax liability.[49] Barclays then deducted the $11 payment from its U.K. tax liability, gaining "an additional $3.30 in tax benefit,"[50] giving Barclays a total of $7.70 in tax benefits for every $100 of trust income.[51]

Meanwhile, although BNY had to pay $22 in taxes to the U.K., it was reimbursed for half of that amount when it received the $11 tax-spread payment from Barclays, all the while still claiming the entire $22 as a foreign tax credit on its U.S. return.[52] This allowed BNY to enjoy a "total net gain of $11" for every $100 of trust income, a profit from the transaction that it would not have enjoyed but for the tax treatment of the transactions that took place using the initial $100 in trust income.[53]

Tax revenue to the U.K. and the U.S. based on BNY and Barclays' use of

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[42] *Id.* at 111-12.
[43] *Id.* at 111.
[44] *Id.*
[45] *Id.*
[46] *Id.*
[47] *Id.*
[48] *Id.* $23.40 - $8.00 = $15.40.
[49] *Id.*
[50] *Id.* $11.00 x 30% = $3.30.
[51] *Id.* $15.40 - $11.00 + $3.30 = $7.70.
[52] *Id.*
[53] *See id.*

the STARS transaction was negligible.[54] For every $100 in trust income generated, the U.K. would receive $3.30,[55] and the U.S. would receive nothing, even though, during 2001 and 2002, BNY received $198.9 million in foreign tax credits and $7.6 million in interest expense deductions to offset "unrelated income" and reduce its U.S. tax liability.[56] As a result of the transaction, both the foreign and the domestic banks enjoy substantial tax benefits in their respective home countries.[57] The IRS has been particularly concerned with the STARS transaction over the last few years because one of its tax effects is the domestic bank's ability to generate "a total net gain due to the tax spread and [claim] a foreign tax credit for the total amount paid in [foreign] taxes, despite [the foreign bank] reimbursing [the domestic bank] for half."[58]

In practice, the STARS transaction is comprised of an exceedingly complex set of arbitrage transactions that result in a foreign tax credit-producing tax shelter.[59] In fact, the Tax Court spent more than ten pages trying to flesh out the entire transaction.[60] However, the ultimate issue concerning taxpayers' use of the STARS transaction is whether foreign taxes paid out should qualify as costs to be deducted in the calculation of pre-tax profit for the purposes of the economic substance doctrine. This same issue arose almost a decade earlier in cases that considered the economic substance of ADR transaction, and it remains important to consider this issue because the courts dealing with those cases came to a different conclusion than that

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[54] *Id.*

[55] *Id.* $22 - ($15.40 + $3.30) = $3.30.

[56] *Id.* at 111-12.

[57] Lubrano, *supra* note 35, at 540.

[58] *Id.*

[59] The First Circuit stated that its opinion in *Santander Holdings USA* did not rely on the opinion of the tax court in *Bank of New York Mellon* and, as such, did not address the argument "that the judge in that case suffered from a conflict of interest." *Santander Holdings USA*, 844 F.3d at 18 n.1. *See* Bank of N.Y. Mellon Corp. v. Comm'r, 140 T.C. 15, 18-29 (2013) for Judge Kroupa's complete explanation of the STARS transaction. One curious aspect of the *Bank of New York Mellon* case is worth noting. In April 2016, Judge Kroupa was indicted on charges of tax fraud. *Former United States Tax Court Judge Pleads Guilty to Conspiring to Defraud the IRS of $450,000 in Taxes*, U.S. DEPT. OF JUSTICE (Oct. 21, 2016), https://www.justice.gov/usao-mn/pr/former-united-states-tax-court-judge-pleads-guilty-conspiring-defraud-irs-450000-taxes [https://perma.cc/QZ9W-8ZQ9]. She later pleaded guilty to conspiring to defraud the IRS of $450,000 in taxes in United States District Court. *Id.* It is unclear whether her guilty plea will make any of her previous rulings "vulnerable to challenge." *See* Dolores Gregory & Erin McManus, *Indictment of Tax Judge a 'Head-Scratcher' for Practitioners*, BLOOMBERG BNA (Apr. 7, 2016), https://www.bna.com/indictment-tax-judge-n57982069585/ [https://perma.cc/3YCQ-TMEZ].

[60] *See Bank of N.Y. Mellon Corp.*, 140 T.C. at 18-29.

of the courts dealing with the STARS transaction.[61]

B. *The Structure of the ADR Transaction*

The ADR transaction can be thought of as a relatively simple predecessor to the STARS transaction. Two major cases that deal with taxpayer use of the ADR transaction are *Compaq Computer Corp. v. Commissioner*,[62] and *IES Industries v. United States*.[63] The transaction was first marketed in the early 1990's as a mechanism that would allow taxpayers to reduce their income tax burdens.[64] The ADR transaction, like the STARS transaction, brought before the courts the divisive issue of whether foreign taxes paid by the U.S. taxpayer as a result of the transaction should qualify as costs that can be deducted in the calculation of pre-tax profit for the purpose of applying the economic substance doctrine.

ADRs are "trading unit[s] issued by a trust, which represent ownership of stock in a foreign corporation that is deposited with the trust."[65] According to the *Compaq* court, ADRs "are the customary form of trading foreign stocks on U.S. stock exchanges."[66] To perform the transaction, U.S. taxpayers, like Compaq and IES, purchased ADRs with effective trade dates "at a time after the declaration of a dividend but before the record date for the payment of dividends."[67] This ensured that the taxpayers would be entitled to receive the dividends when they were paid.[68] When foreign corporations eventually paid the dividends out to the taxpayers, those corporations had to withhold taxes at a fifteen percent rate pursuant to the tax treaties that had been negotiated between the foreign corporations' countries and the U.S.[69] The result was that the taxpayers actually received eighty-five percent of the dividend, reported the entire dividend as gross income on their tax returns, and then claimed a foreign tax credit based on the fifteen percent withholding tax.[70]

The ADRs were sold to the taxpayers at "market price plus [eighty-five] percent of the ADR's expected gross dividends" by tax-exempt entities that had no use for the foreign tax credits generated by the foreign companies'

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[61] Temkin, *supra* note 13, at 1-2.

[62] *Compaq Computer Corp.*, 277 F.3d at 779.

[63] *IES Indus.*, 253 F.3d at 350.

[64] Bryan Camp, *Form Over Substance in Fifth Circuit Tax Cases*, 34 TEX. TECH L. REV. 733, 746-47 (2003).

[65] Compaq Computer Corp. v. Comm'r, 113 T.C. 214, 215 (1999).

[66] *Id.*

[67] James A. Doering, *The Battle Over Corporate Tax Shelters Moves to the Appellate Courts*, 80 TAXES 23, 31 (2002).

[68] *Id.*

[69] *Id.*

[70] *Id.*

withholding.[71] Almost immediately after the taxpayers purchased the ADRs, they would turn around and sell them at fair market value, this time with an effective trade date that came after the record date.[72] The taxpayers' purchase and resale of the ADRs generated a net capital loss because the initial purchase price exceeded the subsequent sale price.[73] The taxpayers could use these capital losses to offset any other capital gains.[74]

Using the quantities at issue in *Compaq*,[75] the following example illustrates the practical operation of the ADR transaction as a tax shelter. As shown in Table 1, the transaction acts as a tax shelter because, while it produces little to no gain to the investor before taxes are taken into account, the investor receives an after-tax profit.

TABLE 1. SAMPLE APPLICATION OF ADR TRANSACTION AS A TAX SHELTER[76]

	Before Tax ($)	**After Tax ($)**
Purchase Price	(887,600,000)	(887,600,000)
Dividend	22,500,000	22,500,000
Foreign Tax	(3,400,000)	(3,400,000)
U.S. Tax on Dividend	-	(7,875,000)
Credit Against U.S. Tax	-	3,400,000
Sale Proceeds	868,500,000	868,400,000
Capital Loss (35% x (22.5M – 3.4M))	-	6,685,000
Total	0	2,110,000

The economic effect to the taxpayer, including the value of the foreign tax credit, was a capital gain equal to the dividend received, less the capital loss on the resale of the ADRs, resulting in an overall gain.[77] However, looking only at the non-tax substance of the transaction and ignoring the foreign tax credits generated, the overall transaction would result in a loss given that the capital loss plus the foreign taxes paid out exceeded the dividend amount.[78] Therefore, the transaction was functionally a tax shelter in that it was only

[71] *Id.*

[72] *Id.*

[73] *Id.*

[74] *Id.*

[75] *See Compaq Computer Corp.*, 277 F.3d at 780.

[76] *See id.*

[77] *See* Matthew Piper, *Gimme Shelter: How the Accountant's Contingency Fee and the Attorney's Opinion Letter Have Contributed to the Proliferation of Abusive Tax Shelters*, 83 N.D. L. REV. 261, 268 n.64 (2007).

[78] *See id.*

profitable to the taxpayer due to the advantageous tax result. In sum, the ADR tax shelter is essentially "an arbitrage transaction involving the purchase and sale of ADRs."[79]

III. ANTI-AVOIDANCE LAW AND THE ECONOMIC SUBSTANCE DOCTRINE

One important feature that distinguishes permissible tax planning from impermissible tax avoidance in any given transaction is economic substance. The U.S. has traditionally taken a substance over form approach to distinguish transactions that unlawfully avoid taxes from those that simply minimize a taxpayer's tax burden to an extent that is consistent with the intent of the taxing statute.[80]

In *Helvering v. Gregory*, Judge Hand declined to apply a purely textualist approach to the interpretation of tax statutes.[81] Instead, he decided that any "[t]ransactions lacking economic and business purpose, other than to capture a tax advantage by meeting specific statutory requirements fail [the 'substance over form'] judicial test."[82] More simply stated, *Gregory* stands for the proposition that transactions that only exist for participants to take advantage of their associated tax benefits, without legitimate business-related purposes, will be deemed to lack economic substance.[83] Courts will therefore deny any tax benefits that the participants sought to enjoy.[84]

The courts have developed a substantial body of anti-avoidance common law,[85] which has interacted with tax statutes to create a rather complex doctrine. To further supplement this doctrine, Congress has enacted a variety of "general anti-avoidance rules" ("GAARs") and routinely modifies taxing statutes to close loopholes revealed by transactions arising from aggressive tax planning.[86] In 2010, in an effort to clarify the somewhat muddled common law that produced the economic substance doctrine, Congress added Section 7701(o) to the Code.[87] Section 7701(o) sets out a two-part test that can be implemented to determine whether a transaction has "economic

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[79] Clifford D. Cohn, *Foreign Tax Credit Denied to Sham Tax Avoidance Transaction: Compaq Computer Corp. v. Commissioner*, 53 TAX LAW 749, 749 (2000).

[80] Ordower, *supra* note 6, at 50.

[81] *Gregory*, 69 F.2d at 810-11; Ordower, *supra* note 6, at 50-51.

[82] Ordower, *supra* note 6, at 51.

[83] *Id.* at 50-51.

[84] *See id.*

[85] *See id.* at 51. ("In the United States, courts have applied interpretive glosses like the sham transaction, business purpose, economic substance and substance over form doctrines to prevent tax reducing schemes.").

[86] *See id.* at 51-52.

[87] *Bank of N.Y. Mellon Corp.*, 801 F.3d at 115 n.7.

substance" in the event that a court decides to apply the doctrine.[88] The test states that a transaction is to be "treated as having economic substance only if (a) the transaction changes in a meaningful way . . . the taxpayer's economic position, and (b) the taxpayer has a substantial purpose . . . for entering into such transaction."[89]

IV. THE ECONOMIC SUBSTANCE DOCTRINE AND FOREIGN TAX CREDITS

Courts may choose to apply the now-clarified economic substance doctrine in cases where taxpayers claim tax advantages that carry potential for abuse.[90] Examples of such potentially abusive advantages include the foreign tax credit and other special tax benefits. When the U.S. income tax was born in 1913, taxpayers were permitted to deduct foreign tax expenses.[91] In 1918, Congress switched gears and decided to grant foreign tax credits to taxpayers who pay income taxes to foreign governments.[92] The reasoning behind the government's allowance of this dollar-for-dollar credit against U.S. federal income taxes stems from two fundamental attributes of the U.S.'s income tax system: (1) taxation on the worldwide income of its taxpayers and (2) a general aversion to double taxation.[93]

The U.S. taxes resident aliens and citizens on their worldwide income.[94]

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[88] *Id.*; I.R.C. § 7701(o) (2012) (clarifying out the objective and subjective prongs of the two-part economic substance test).

[89] I.R.C. § 7701(o) (2012).

[90] Bankman, *supra* note 29, at 5-6 ("The recent phenomenon of corporate tax shelters has produced a resurgence in the use of common law [anti-abuse] doctrines . . . . [C]ourts have . . . used common law doctrines to deny tax benefits to shelter participants . . . . [T]he economic substance doctrine has played a particularly important role in the government's fight against corporate shelters.").

[91] Michael J. Graetz, *Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies*, 26 BROOK. J. INT'L L. 1357, 1357 (2001).

[92] *Id.*

[93] James P. Fuller, Frederick R. Chilton, Jr. & Ronald B. Schrotenboer, *The Foreign Tax Credit*, 5 HASTINGS INT'L COMP. L. REV. 633, 633-34 (1981) ("Under United States tax law, United States residents and corporations are taxed on their worldwide income . . . . When income is earned outside the United States, it is usually also taxed in the country in which it originates. As a result, the problem of international double taxation arises. The principal method of coping with international double taxation by the United States is by means of the foreign tax credit[, which] is a dollar-for-dollar credit against U.S. income tax liability for income taxes paid to foreign countries . . . . During World War I . . . the tax rates in the United States and abroad increased . . . highlight[ing] the problem of double taxation of foreign income . . . . In order to minimize these problems, Congress enacted the foreign tax credit in 1918.").

[94] *Id.*; I.R.C. § 61(a) (2012) (defining "gross income" to include "all income *from whatever source derived*") (emphasis added); *Income from Abroad is Taxable*, IRS, https://www.irs.gov/businesses/income-from-abroad-is-taxable [https://perma.cc/NRZ7-

The U.S. is one of the only developed countries that imposes income taxes on the basis of worldwide income.[95] Taxation on worldwide income, by its very nature, increases the danger of double taxation.[96] By taxing income sourced from outside of the U.S., the government risks reaching income that has already been subject to income tax by a foreign government. This is where the foreign tax credit becomes relevant to the discussion. To reduce the chance of double taxation, Congress introduced the foreign tax credit, which grants a "dollar-for-dollar" tax credit that can be used to offset U.S. income tax liability.[97] Generally speaking, if a taxpayer "paid or accrued foreign taxes to a foreign country or U.S. possession and is subject to U.S. tax on the same income, [the taxpayer] may be able to take either a credit or an itemized deduction for those taxes."[98]

The allowance of foreign tax credits has also opened an extra door to abusive tax avoidance. Certain tax shelters involve the production of foreign tax credits using "transactions designed to create a tax arbitrage."[99] As a result, courts have determined that certain tax benefits, like foreign tax credits, should be reserved for valid transactions with "economic substance."[100]

V. THE ISSUE AND ITS SOLUTION

A. *The Issue with Calculating Pre-Tax Profit*

As previously noted, in 2010, Congress clarified the economic substance

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6ZY3].

[95] *See* Kyle Pomerleau, *Worldwide Taxation is Very Rare*, TAX FOUND. (Feb. 5, 2015), https://taxfoundation.org/worldwide-taxation-very-rare/ [https://perma.cc/T35C-CK3G] ("At the beginning of the 20th century, 33 countries had a worldwide tax system. That number slowly dropped to 24 countries by the 1980s. By the 2000s, the number of countries switching to territorial systems accelerated, with more than 10 countries switching in 10 short years. Nearly all developed countries have moved to the superior territorial tax system. Today there are only 6 countries that tax corporations on their worldwide income.").

[96] *See Bank of N.Y. Mellon Corp.*, 801 F.3d at 107.

[97] *See id.*

[98] *Foreign Tax Credit*, IRS, https://www.irs.gov/individuals/international-taxpayers/foreign-tax-credit [https://perma.cc/94YY-Z39L].

[99] *See* Temkin, *supra* note 13, at 1.

[100] *See* Lubrano, *supra* note 35, at 537-38 n.6 ("In *Bank of New York Mellon Corp. v. C.I.R.*, the United States Court of Appeals for the Second Circuit . . . held that the economic substance doctrine could be applied to foreign tax credits, determining both corporations' transactions to be sham transactions . . . . In its reasoning, the Court looked to precedent cases that applied the economic substance doctrine to similar transactions.")

doctrine in Section 7701(o)[101] of the Code.[102] There is currently a circuit split regarding the question of whether foreign taxes paid out should qualify as costs to be deducted in the calculation of pre-tax profit for the purposes of the economic substance doctrine. This is a point upon which the Fifth and Eighth Circuits (the "ADR Courts") appear to disagree with the First, Second, and Federal Circuits (the "STARS Courts").[103]

The Supreme Court should resolve the issue in favor of the STARS Courts' reasoning. Those courts had the chance to interpret and apply the economic substance doctrine to transactions that produce foreign tax credits, while the ADR Courts made their decisions nearly a decade before Congress acted. A resolution of this issue would also (1) provide doctrinal clarity for tax planners, taxpayers, and the government, which could both reduce future litigation and transaction costs and preserve the IRS's limited resources, and (2) reduce the chance of forum shopping by equalizing the playing field among the circuits. The next section will argue for a resolution in favor of the STARS Courts. Their reasoning is based on both political and economic reality and is firmly grounded in both the language and intent of the doctrine, which was clarified in the Code *after* the decisions of the ADR Courts.

B. *Why the Inclusion of Foreign Taxes in Calculating Pre-Tax Profit Matters*

The Supreme Court declined to resolve the circuit split in 2016.[104]

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[101] I.R.C. § 7701(o)(5)(A) (2012). Defining "economic substance doctrine" to mean "the common law doctrine under which tax benefits under subtitle A with respect to a transaction are not allowable if the transaction does not have economic substance or lacks a business purpose." *Id.*

[102] Lubrano, *supra* note 35, at 542-43.

[103] *Compare Compaq Computer Corp.*, 277 F.3d at 782-84 ("[T]he [Tax C]ourt treated the Netherlands tax as a cost of the transaction . . . . The Tax Court's decision is in conflict with *IES Indus., Inc v. United States*, 253 F.3d 350 (8th Cir. 2001). . . . We agree with the *IES* court and conclude that the Tax Court erred as a matter of law by . . . ignoring Compaq's pre-tax profit on the ADR transaction."), *and IES Indus.*, 253 F.3d at 354 ("[T]he economic benefit to IES was the amount of the *gross* dividend, before the foreign taxes were paid."), *with Bank of N.Y. Mellon Corp.*, 801 F.3d at 116-18 (detailing the other circuits' "disparate approaches" to determine whether, for purposes of the economic substance doctrine, foreign taxes paid should be considered costs when calculating pre-tax profit, and concluding that it is appropriate for courts, when evaluating the economic substance of a transaction, to treat foreign taxes as costs), *Salem Fin.*, 786 F.3d at 947-48 (declining to follow the Fifth and Eighth Circuits' reasoning that the analysis should either consider all tax law effects—both foreign tax credits and foreign tax expenses—or none of them), *and Santander Holdings USA*, 844 F.3d at 23-24 (concluding that foreign taxes paid out should be treated as expenses and that when the primary cost of the transaction, the foreign taxes, are factored into the calculation of pre-tax profitability, the STARS transaction is economically profitless).

[104] *Salem Fin.*, 786 F.3d at 932, *cert. denied*, 136 S. Ct. 1366 (2016).

However, the First Circuit soon after exacerbated the split by ruling in favor of the government on its appeal in *Santander*, which concerned the issue of whether foreign taxes paid should count as expenses in the context of STARS transactions.[105] Unsatisfied with the outcome of the First Circuit decision, Santander petitioned the Supreme Court for review in March 2017,[106] a review that the Supreme Court would have done well to grant. Resolution of the circuit split would have significant implications for U.S. taxpayers and tax planners that structure transactions with the foreign tax credit in mind. Without review, the economic substance doctrine's effects on the ability of U.S. taxpayers to claim foreign tax credits will remain uncertain. However, the Supreme Court once again declined to resolve the split by denying Santander's petition for *certiorari*.[107]

In the early 2000's, the Fifth and Eighth Circuits consecutively held that foreign taxes should not be counted in calculating pre-tax profit for purposes of applying the economic substance doctrine.[108] More than a decade later, the First, Second, and Federal Circuits have weighed in on the issue and have come to the opposite conclusion, holding that foreign taxes paid *should* be counted for this purpose, thus creating the split.[109] However, there is a distinction in the case law in that the First, Second, and Federal Circuit cases deal with taxpayers who participated specifically in STARS transactions, unlike the Fifth and Eighth Circuit cases, which deal with taxpayers who participated in ADR transactions.[110] As noted above, in comparison to the STARS transaction, the ADR transaction is relatively simple.[111]

Despite this difference, both transactions have provided occasions for all five courts to weigh in on the issue. For purposes of properly resolving the underlying issue, the differences between the transactions should be disregarded. Though various courts and commentators have disagreed upon whether the difference in transaction choice affects the analysis of the issue,[112] it should not matter whether the transaction that generated foreign

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[105] *See* Santander Holdings USA v. United States, 144 F. Supp. 3d 239 (D. Mass. 2015), *rev'd*, 844 F.3d 15 (2016).

[106] *Santander Holdings USA*, 844 F.3d 15, *petition for cert. filed*, (85 U.S.L.W. 3599) (U.S. Mar. 16, 2017) (No. 16-01130).

[107] *Santander Holdings USA*, 844 F.3d 15, *cert. denied*, 137 S. Ct. 2295 (2017).

[108] *See Compaq*, 277 F.3d at 782-84.

[109] *See Salem Fin.*, 786 F.3d at 932; *Bank of N.Y. Mellon Corp.*, 801 F.3d at 118; *Santander Holdings USA*, 844 F.3d at 24 n.11.

[110] *See* Temkin, *supra* note 13, at 2.

[111] *Id.* at 2.

[112] *See, e.g.*, *Santander Holdings USA*, 844 F.3d at 24 n.11 ("Sovereign and the district court rely heavily on *Compaq* and *IES* for the proposition that foreign taxes should not be treated as expenses . . . [but t]hose cases did not analyze STARS transactions and so are distinguishable factually."). *But see, e.g.*, Temkin, *supra* note 13, at 1-2 (treating the STARS

tax credits consisted of one step or twenty; the application of the economic substance doctrine should be uniform. Ultimately, the STARS Courts provided convincing support for their decisions to reject the ADR Courts' reasoning, for their conclusions that "foreign taxes are economic costs and should thus be deducted when calculating pre-tax profit," and for their rulings that the court should "include the foreign taxes paid and . . . exclude the foreign tax credits claimed."[113]

C. *Inconsistency in the Calculation of Pre-Tax Profit*

Three major cases deal with the issue at hand in the context of the STARS transaction: *Bank of New York Mellon Corp. v. Commissioner*,[114] *Salem Financial v. United States*,[115] and *Santander*.[116] In *BNY Mellon* and *Salem*, the trial courts held that the STARS transaction lacks economic substance.[117] In *Santander*, the trial court granted summary judgment for Santander on the issue of whether certain payments from Barclays to Santander were to be counted as revenue in deciding whether the STARS transaction had a reasonable outlook in terms of actually producing profit.[118] On appeal to the First Circuit, the court reversed the lower court's decision and instead held in favor of the government, in many respects closely following the logic applied by the *Salem* and *BNY Mellon* courts.[119]

The two remaining relevant cases are *Compaq*[120] and *IES*.[121] These cases, decided by the Fifth and Eighth Circuits respectively, deal with the fate of foreign tax credits that resulted from the taxpayers' participation in ADR transactions.[122] The Second Circuit, Federal Circuit, and, most recently, the First Circuit each declined to apply the *Compaq* and *IES* courts' logic for slightly varied reasons,[123] with the First Circuit in particular relying on

and ADR transactions as functionally equivalent in analyzing the courts' calculation of pre-tax profit).

[113] *Bank of N.Y. Mellon Corp.*, 801 F.3d at 124.

[114] *Id.* at 104-05.

[115] *See Salem Fin.*, 786 F.3d at 932.

[116] *See Santander Holdings USA*, 844 F.3d at 15.

[117] 106 T.C.M. (CCH) 367, 369 (2013); 112 Fed. Cl. 543, 549 (2013).

[118] *Santander Holdings USA*, 114 F. Supp. 3d at 239.

[119] *See Santander Holdings USA*, 844 F.3d at 26.

[120] *Compaq Computer Corp.*, 277 F.3d at 778.

[121] *IES Indus.*, 253 F.3d at 350.

[122] *See* Temkin, *supra* note 13, at 2 ("Unlike the complex transactions addressed by the Second Circuit, *Compaq* and *IES* examined relatively straightforward transactions involving American Depositary Receipts (ADRs), in which the taxpayer purchased shares of a foreign corporation immediately before it paid out dividends that were subject to foreign taxes.").

[123] *Santander Holdings USA,* 844 F.3d at 22-23.

factual distinctions between the cases.[124] On appeal to the First Circuit in *Santander*, the court relegated its dismissal of *Compaq* and *IES* to a single footnote, which stated that "[Santander] and the district court rely heavily on *Compaq* and *IES* for the proposition that foreign taxes should not be treated as expenses . . . [but t]hose cases did not analyze STARS transactions and so are distinguishable factually."[125]

Despite the disputed differences between the transactions, the Fifth and Eighth Circuits dealt with the same issue as the STARS courts. Additionally, the Fifth and Eighth Circuits failed to analyze the issue in its entirety before holding that foreign taxes paid should not be counted as an expense in calculating pre-tax profit for purposes of the economic substance doctrine. Instead, they concentrated almost exclusively on Congress's goal of preventing double taxation when it introduced the foreign tax credit, without giving much weight to the economic implications of the foreign taxes.[126] The government was more persuasive in *Santander*, *Salem*, and *BNY Mellon* where it argued that the STARS transactions lack economic substance, and the taxes paid to foreign governments as a result of the transactions should be calculated as expenses in assessing pre-tax profit.

VI. COURT APPLICATIONS OF THE ECONOMIC SUBSTANCE DOCTRINE

A. *The ADR Courts*

1. The Eighth Circuit's Approach in *IES*

The Eighth Circuit first took up this issue in analyzing appellant IES's use of the ADR transaction.[127] To carry out the ADR transaction, which was proposed to IES in 1991 by a New York-based securities broker called Twenty-First Securities Corporation ("Twenty-First"), IES participated in a series of stock trades.[128] To begin, Twenty-First identified ADRs owned by companies that routinely declared dividends.[129] IES then purchased ADRs with an effective trade date that was "before the record date for the dividend, so that IES was the owner on the record date and therefore entitled to be paid the dividend."[130] IES then turned around and immediately sold the ADRs, with an effective trade date after the record date.[131]

[124] *Id.* at 24 n.11.
[125] *Id.*
[126] Temkin, *supra* note 13, at 1-2.
[127] *IES Indus.*, 253 F.3d at 350-52.
[128] *See id.* at 352.
[129] *Id.*
[130] *Id.*
[131] *Id.*

The original sellers of the ADRs were exempt from U.S. income tax, but were still required to pay foreign taxes on any ADR dividends that they received.[132] As such, they had no use for any U.S. foreign tax credits generated by the transaction.[133] Through another series of transactions involving a counterparty chosen by Twenty-First,[134] IES ultimately purchased ADRs with dividend rights attached, after paying fees to both Twenty-First and the counterparty, for a higher price than it sold them without dividend rights.[135] This caused IES to incur capital losses, which IES sought to carry back in order to offset its 1989 and 1990 capital gains.[136] Even though it generated capital losses, IES profited from the transaction because it received dividends declared that "exceeded [its] capital losses."[137] IES then paid a foreign tax equal to fifteen percent of the dividend, which permitted it to claim the same amount in U.S. foreign tax credits.[138]

On audit, the IRS disallowed the foreign tax credits generated by IES's ADR transaction.[139] The government rejected IES's refund claim, and IES subsequently filed suit in district court, which granted summary judgment to the government because it found that the transactions "were shaped solely by tax avoidance considerations, [and] had no other practical economic effect."[140] In coming to its conclusion that the transaction was a sham, the court implemented a two-prong test, which characterizes a transaction as a sham if "'it is not motivated by any economic purpose outside of tax considerations' . . . and if it 'is without economic substance because no real potential for profit exists.'"[141] The court stated in dictum that failure on either prong of the test would require the conclusion that the given transaction is a

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[132] *Id.*

[133] *Id.*

[134] *Id.* The transactions in question took place as follows: "Before the dividend record date, the tax-exempt holders of the ADRs loaned them to a counterparty." *Id.* Next, the counterparty "sold the ADRs short . . . to IES," which became the "owner of the ADRs with full right, title, and interest in the ADRs." *Id.* The counterparty then repurchased the ADRs, after dividends accrued to IES, for a price "equal to market price plus 85% of the ADRs' expected gross dividends." *Id.* The purchase price was therefore the same as the "amount the ADR lender would have received after foreign tax was withheld had it been the record owner entitled to payment of the dividends." *Id.* The lender also received a cash deposit as collateral, generally equal to "102% of the market value of the ADRs on loan. The lender would have that collateral available to invest during the term of the loan of the ADRs, thus earning a profit on its loan . . . . IES [then] sold the ADRs back to the lenders at market price." *Id.*

[135] *IES Indus.*, 253 F.3d at 352.

[136] *Id.*

[137] *Id.* The dividends were taxable as ordinary income.

[138] *Id.*

[139] *Id.* at 353.

[140] *Id.* (internal quotation marks omitted).

[141] *Id.* (citing Rice's Toyota World v. Comm'r, 752 F.2d 89, 91-92 (4th Cir. 1985)).

sham.[142]

On appeal, the Eighth Circuit took a different approach and reversed the lower court, finding that the ADR transaction as performed by IES had, in fact, both economic substance and a business purpose.[143] The Eighth Circuit decided the issue by first applying the "objective economic substance test" and declining to comment on the district court's note that failure of either prong of the test would invalidate a transaction for purposes of the economic substance doctrine.[144] To apply the economic substance test, the court first considered "whether there was a 'reasonable possibility of profit . . . apart from tax benefits,'" i.e. whether the ADR transaction had economic substance.[145] In doing so, it endorsed IES's argument that the economic benefit to IES was equal to the amount of the gross dividend "before the foreign taxes were paid," that IES was "the legal owner of the ADRs on the record date," and that, as such, it was "legally entitled to retain the benefits of ownership, that is, the dividends due on the record date" as income.[146] The court went on to conclude that, because IES received income in the form of dividends as a result of the transaction, the transaction resulted in profit, which was to IES's economic benefit.[147]

The court then moved on to apply the subjective business purpose test, laid out in *Rice's Toyota World* and *Shriver*, to determine "whether the taxpayer was induced to commit capital for reasons only relating to tax considerations or whether a non-tax motive, or legitimate profit motive, was involved."[148] In doing so, the court noted that the "taxpayer's subjective intent to avoid taxes" does not on its own control the outcome because, as Judge Hand tells us, taxpayers have a right to avoid paying higher taxes.[149] As to the subjective part of the test, the court again endorsed IES's argument. It acknowledged that, although IES had minimal risk of loss on the trades involved, the companies dealt with each other at arm's length, which was enough to evince a legitimate business purpose or "subjective intent to treat the ADR trades as money-making transactions."[150]

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[142] *Id.*

[143] *Id.* at 356.

[144] *Id.* at 353-54 ("As in *Shriver*, we do not decide whether the *Rice's Toyota World* test requires a two-part analysis because we conclude that the ADR trades here had both economic substance and business purpose.").

[145] *Id.* at 354 (citing Shriver v. Comm'r, 899 F.2d 724, 726 (1990)).

[146] *Id.*

[147] *Id.*

[148] *Id.* at 354-55 (citing *Shriver*, 899 F.2d at 726) (internal quotation marks omitted).

[149] *Id.* at 355.

[150] *Id.* (referencing the tax court's decision in *Compaq*, which stated that that taxpayer, participating in the same transaction, lacked a business purpose because the taxpayer's evaluation of the transaction was less than businesslike, with taxpayer's assistant treasurer

After resolving both prongs of the two-part *Rice's Toyota World* test for economic substance in favor of IES, the Eighth Circuit held that "the ADR trades in which IES engaged did not, as a matter of law, lack business purpose or economic substance."[151] This decision granted IES its tax refund and, in failing to take into account the foreign taxes paid by IES in calculating pre-tax profit potential, struck a blow to the government with respect to the application of the economic substance doctrine to the issue at hand.[152]

2. The Fifth Circuit's Approach in *Compaq*

In *Compaq*, the taxpayer bought, and shortly thereafter sold, ten million Royal Dutch ADRs in a series of twenty-three trades and recognized a capital loss of $20.7 million.[153] Through its initial ADR purchases, the taxpayer became the shareholder of record for the ADRs on the date that dividends were declared.[154] The taxpayer received the dividends, then reported $22.5 million in dividend income, and the Dutch government withheld taxes on that income in the amount of $3.4 million.[155] The $19.2 million net dividend that the taxpayer retained effectively offset the capital loss that the buy-sell trades generated.[156] Without taking U.S. tax consequences into account, the net effect was that the taxpayer sustained a net cash flow loss equal to about $1.5 million in transaction costs.[157]

The IRS initially denied Compaq a foreign tax credit worth $3.4 million, representing the amount withheld by the Netherlands, arguing that Compaq's ADR transaction lacked economic substance.[158] On appeal, the Tax Court held that "because the ADR transaction lacked economic substance, the transaction should be disregarded for federal income tax purposes."[159] For these reasons, the court entered judgment for the commissioner, denying Compaq the foreign tax credit and ordering Compaq to pay the $3.4 million differential.[160]

On appeal to the Fifth Circuit, the *Compaq* Court closely followed the Eighth Circuit's approach in *IES*, which had been decided just months

committing the taxpayer to a multimillion-dollar transaction based on a single meeting with Twenty-First and one call to a Twenty-First agent).

[151] *Id.* at 356.

[152] *See id.*

[153] *See Compaq Computer Corp*., 277 F.3d at 780.

[154] *Id.*

[155] *Id.*

[156] *See id.*

[157] *Id.* at 782.

[158] *Id.* at 780.

[159] *Id.* at 779.

[160] *See Compaq Computer Corp.*, 113 T.C. at 214, 222.

before.[161] The court first noted that, unlike IES, Compaq actually knew very little about the transaction before participating. In a conclusion similar to the Eighth Circuit, the Fifth Circuit found that Compaq's ADR transaction was not a sham performed *solely* for tax avoidance purposes, but rather had both economic substance and business purpose.[162]

In rejecting the Tax Court's reasoning that the transaction had no economic substance, the Fifth Circuit said that the lower court looked neither to the pre-tax nor the post-tax profitability of the transaction, but instead based its profit analysis on the part of the transaction that occurred "after Netherlands tax had been imposed but before considering U.S. income tax consequences."[163] Essentially, the Fifth Circuit determined that the Tax Court erred in its analysis of the transaction's economic substance *because* it treated the tax paid to the Netherlands by Compaq as a cost of the transaction without treating the U.S. foreign tax credit as a corresponding benefit.[164] This reasoning, which led to the court's ultimate holding that the ADR transaction possessed economic substance, is in direct conflict with the reasoning implemented by the STARS Courts.

B. *The STARS Courts*

1. The Federal Circuit's Approach in *Salem*

In *Salem*, the Federal Circuit analyzed the appellant's use of the STARS transaction to generate foreign tax credits as an issue of first impression among the Circuits.[165] As previously noted, STARS transactions consist of two major parts: (1) a trust, and (2) a loan.[166] To set up the STARS transaction, the domestic bank, BB&T, first created a trust with a U.K. tax paying resident as trustee, using its U.S.-based income-generating assets.[167] The trust had to pay taxes to the U.K. because the trustee was a U.K. resident and taxpayer.[168] The foreign taxes paid out by the trust, which was controlled by the U.S.-based entity, entitled the domestic controller to a foreign tax credit that could later be used to reduce its overall U.S. tax burden.[169]

Next, the foreign bank, Barclays, provided BB&T with a loan deposited

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[161] *See Compaq Computer Corp.*, 277 F.3d at 782-83.
[162] *See id.* at 778-88.
[163] *Id.* at 782.
[164] *Id.*
[165] *See Salem Fin.*, 786 F.3d at 932.
[166] *Id.* at 937.
[167] *Id.*
[168] *Id.* at 937.
[169] *Id.* at 936.

into BB&T's U.K.-based trust.[170] Barclays then received "equity interests in the [t]rust," meaning that it was given shares of the trust.[171] However, BB&T always maintained control over the trust and, upon termination of the transaction, Barclays was "contractually obligated to sell its interests in the [t]rust back to BB&T."[172] The net effect of these steps was that BB&T received a large loan from Barclays.[173]

BB&T periodically received "distributions of the income generated from the assets held by the [t]rust," which can be considered dividends.[174] These distributions consisted of the portion of the income generated that was left over after an amount had been set aside to pay the foreign taxes owed, as well as various fees.[175] Before handing over the distributions to BB&T, Barclays temporarily placed them in a "blocked account" at BB&T, which "immediately returned [the] funds to the [t]rust."[176] The "circular movement" of the cash distributions allowed Barclays "to claim a 'trading loss deduction'" under U.K. tax law, which created a tax benefit for Barclays.[177]

The final part of Salem's version of the STARS transaction was a payment made to BB&T by Barclays.[178] This payment was "equal to 51% of the [United Kingdom] taxes paid by the [t]rust," which BB&T had previously paid and "which resulted in the tax benefits obtained by Barclays."[179] BB&T's "interest obligation" for the loan from Barclays and Barclays' "payment obligation" to BB&T were "netted against each other" each month.[180] In the context of the transaction discussed in *Salem*, Barclays made payments to BB&T each month because "Barclays' . . . payment obligation exceeded the amount of BB&T's interest obligation."[181]

The *Salem* court ultimately decided to compute pre-tax profit by including the taxes paid out to foreign governments as a cost.[182] In support of this decision, the court explained that

> The critical question is not whether the transaction would produce a net gain after all tax effects are taken into consideration; instead, the

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[170] *Id.*
[171] *Id.* at 937.
[172] *Id.*
[173] *Id.*
[174] *Id.*
[175] *Id.*
[176] *Id.*
[177] *Id.*
[178] *Id.*
[179] *Id.* at 938.
[180] *Id.*
[181] *Id.*
[182] Temkin, *supra* note 13, at 2.

> pertinent questions are whether the transaction has real economic effects apart from its tax effects, whether the transaction was motivated only by tax considerations, and whether the transaction is the sort that Congress intended to be the beneficiary of the foreign tax credit provision.[183]

The court, in holding that the STARS transaction "lacked a reasonable profit potential based on treating the foreign taxes paid as a cost, without offsetting that cost with the credits that the tax payments generated,"[184] for the first time diverged from the Fifth and Eighth Circuit in regards to the calculation of pre-tax profit for the purposes of the economic substance doctrine.

2. The Second Circuit's Approach in *BNY Mellon*

In *BNY Mellon*, the Second Circuit Court of Appeals considered the fate of the foreign tax credits taken by BNY and American International Group ("AIG") as a result of their separate participation in variations of the STARS transaction.[185] For its part, AIG participated in six cross-border transactions between 1993 and 1997.[186] To carry out the transactions, AIG set up a Special Purpose Vehicle ("SPV") using a subsidiary called AIG Financial Products ("AIG Financial").[187] The SPV was set up in order to "hold and invest funds in a foreign country," meaning that it functioned essentially in the same way as the trust that BNY used in its own version of the STARS transaction.[188]

AIG Financial sold shares in the SPV to a foreign bank and "committed to repurchasing the shares at a specific future date."[189] The SPV then paid out foreign taxes in order to claim foreign tax credits, and AIG asserted ownership of all shares in the SPV on its U.S. federal income tax returns.[190] At the same time, the participating foreign bank "treated the SPV as its corporate subsidiary and treated the SPV's distributions as tax-exempt dividends, which generated very little tax."[191] The net result of the transaction with respect to AIG was a conversion of interest expenses, which it would have normally had to pay to the foreign bank, into foreign tax credits,

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183 *Salem Fin.*, 786 F.3d at 948.

184 Temkin, *supra* note 13, at 2.

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

186 Lubrano, *supra* note 35, at 538.

187 *Id.* An SPV is "a free-standing entity specifically created for [a] transaction" which can be set up as either a corporation or a trust. Peter F. Culver, *The Dawning of Securitization*, 8 PROB. & PROP. 34, 34 (1994).

188 Lubrano, *supra* note 35, at 538; *see Bank of N.Y. Mellon Corp.*, 801 F.3d at 108-09.

189 Lubrano, *supra* note 35, at 538.

190 *Id.* at 538-39.

191 *Id.* at 539.

which it ultimately attempted to use to mitigate its U.S. income tax liability.[192]

BNY, in a series of transactions implementing strategies similar to AIG's, used the help of Barclays to generate foreign tax credits for use in the five-year period from 2001 to 2006.[193] To perform the STARS transaction and generate the credits, BNY created a Delaware-based trust to which it contributed $7.8 billion worth of "income producing assets."[194] It then followed a pattern of transactions nearly identical to those employed by Salem in its implementation of the STARS transaction.[195] Before either AIG or BNY made it to the Second Circuit, the U.S. District Court for the Southern District of New York and the Tax Court respectively held that "the economic substance doctrine applied to the foreign tax credits" at issue, and that "the tax spread in BNY's transaction should be included in taxable income because it lacked economic substance."[196]

On BNY and AIG's appeal to the Second Circuit, the court acknowledged a split among the circuit courts that had already considered the issue of how to calculate profit in connection with transactions that generate foreign tax credits.[197] This court took the position that foreign taxes paid out to produce the foreign tax credits "should be treated as a cost when calculating a transaction's pre-tax profitability."[198] In doing so, it closely followed the logic applied by the Federal Circuit in *Salem*, which had been decided only four months prior.[199] After assessing the factual distinctions between the three cases that had already been decided on the issue, the Second Circuit ultimately came to the conclusion that "[e]conomically, foreign taxes are the same as any other transaction cost," and that "excluding the economic effect of foreign taxes from the pre-tax analysis would fundamentally undermine the point of the economic substance inquiry."[200]

Finally, after also noting that "profit for purposes of 'economic substance' must be analyzed within the context of the tax implications," the court held that foreign taxes paid should be counted as costs in calculating pre-tax profit for the purposes of the economic substance doctrine.[201] In so holding, the court indicated that its decision, unlike those of the ADR Courts, was

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[192] *Id.*

[193] *Id.*

[194] *Id.*

[195] *See Salem Fin.*, 786 F.3d at 936-39 (describing the structure of a typical adaptation of the STARS transaction)*; id.* at 539-40.

[196] Lubrano, *supra* note 35, at 540.

[197] *Id*.; Temkin, *supra* note 13, at 2.

[198] Temkin, *supra* note 13, at 2.

[199] *See Bank of N.Y. Mellon Corp*., 801 F.3d at 116; *Salem Fin.*, 786 F.3d at 932.

[200] *Bank of N.Y. Mellon Corp.*, 801 F.3d at 117.

[201] *Id.* at 117, 124.

grounded in economic reality and accordingly affirmed the judgment of the Tax Court that the STARS transaction lacked economic substance.[202]

3. The First Circuit's Approach in *Santander*

The First Circuit is the most recent Circuit to weigh in on the issue of foreign tax credits and pre-tax profit calculation for purposes of the economic substance doctrine. It is also the first court to touch on the issue since the Supreme Court declined to grant certiorari to BNY. While the STARS transaction at issue, performed by Santander, took basically the same form as those used by BNY and Salem in the Second and Federal Circuit cases respectively, the First Circuit took a slightly different approach.

In an interesting twist, the First Circuit declined to even consider the wisdom of the ADR Courts in their analysis of the issue. Instead, the court cited obvious "factual differences" between the transactions involved before going on to consider only the reasoning applied by the other STARS Courts.[203] Despite this arguably unnecessary distinction, the First Circuit analyzed the issue of whether to include foreign taxes as expenses when calculating pre-tax profit, which is the same issue that had previously been considered by each of the four aforementioned courts.[204]

The First Circuit ultimately came down on the same side of the pre-tax profit issue as the Second and Federal Circuits. It held that taxes paid to foreign governments should be counted as expenses when pre-tax profit is being calculated for the purpose of applying the economic substance doctrine to a taxpayer's claim of foreign tax credits.[205] In deciding that the STARS transaction lacked economic substance, the Court cited *Salem*'s logic, namely that "[t]he STARS Trust transaction itself does not have a reasonable prospect of creating a profit without considering the foreign tax credits, and, as a result, it is not a transaction for which Congress intended to give the benefit of the foreign tax credit."[206] The court then explained that it came to this decision because the inclusion of foreign taxes as expenses reflects

[202] *See id.* at 124-25.

[203] *Santander Holdings USA*, 844 F.3d at 24 n.11 ("[The ADR] cases did not analyze STARS transactions and so are distinguishable factually.").

[204] *Id.* at 18 ("The [lower] court also denied the government's cross-motion for partial summary judgment in its favor on a number of issues, including whether [Santander's] U.K. taxes should be regarded as expenses in any calculation of [Santander's] profit from the STARS transaction . . . . The government appeals from the grant of summary judgment to [Santander] and the denial of its cross-motion."). *See generally* Temkin, *supra* note 13, at 1-2 (discussing the Federal, Second, Fifth, and Eighth Circuits' divergent decisions regarding the correct treatment of foreign taxes paid out in calculating pre-tax profit for the purposes of applying the economic substance doctrine).

[205] *Santander Holdings USA*, 844 F.3d at 19.

[206] *Id.* at 23.

economic reality by considering a transaction's true profit potential.[207] Extending that argument, the court determined that calculating profit potential in this way naturally brings it to the conclusion that the STARS transaction is ultimately profitless and, as such, cannot have economic substance.[208]

C. *Summary: The STARS Courts' Approach versus the ADR Courts' Approach*

In sum, the STARS Courts' approach to the issue of whether foreign taxes paid as a result of the STARS transaction should be included when calculating pre-tax profit for purposes of the economic substance doctrine diverges from the ADR Courts' approach in that the STARS Courts count foreign taxes as expenses in the calculation, while the ADR Courts do not. The STARS Courts' approaches to calculating pre-tax profit in transactions that generate foreign tax credits diverge significantly from those of the ADR Courts.

In *Compaq* and *IES*, the Fifth and Eighth circuits respectively applied an "objective test of profitability without regard to either foreign taxes paid or the benefits derived from the credits those payments generated."[209] In *Salem*, *BNY Mellon*, and *Santander*, the Federal, Second, and First Circuits were adamant that foreign taxes paid must be considered expenses in calculating pre-tax profit, lest the purpose of the economic substance doctrine be defeated altogether because of a test that lacks grounds in economic reality. The divergent applications of the doctrine among the courts produce widely differing results. As should be expected, the inclusion of foreign taxes paid as an expense in calculating pre-tax profit makes it much more difficult for a taxpayer to show that a tax sheltering transaction actually possesses economic substance based on its profit-making potential. This difference has significant implications for taxpayers and the IRS alike, in that the outcome post-audit for the exact same transaction could differ depending on something as arbitrary as where the taxpayer decides to bring suit.

VII. WHY THE SUPREME COURT SHOULD RESOLVE THE ISSUE USING THE STARS COURTS' APPROACH

The Supreme Court had an opportunity to resolve the circuit split when it recently considered Santander's petition for *certiorari*,[210] which requested review on the issue of whether to include foreign taxes in calculating pre-tax

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[207] *Id.*

[208] *Id.* at 23-24.

[209] Temkin, *supra* note 13, at 2.

[210] *Santander Holdings USA*, 844 F.3d 15, *petition for cert. filed*, (85 U.S.L.W. 3599) (U.S. Mar. 16, 2017) (No. 16-01130).

profit. Despite the Supreme Court's decision to deny Santander's petition,[211] the Court should resolve the split on this issue for two reasons.

First, resolution of this issue would provide much needed clarification in regards to the application of the economic substance doctrine for both taxpayers and the IRS.[212] A Supreme Court endorsement of one Circuit Court's approach or another will allow tax planners to uniformly structure transactions across jurisdictions and should permit taxpayers, especially those subject to the laws of more than one circuit, to more accurately assess the pros and cons of a proposed transaction. A counterargument is that ambiguity in tax law leaves plenty of room for each side to argue one way or another in support of their position,[213] and Supreme Court resolution would preclude the parties from making such arguments in defense of their position. However, the likelihood of success upon arguing over the ambiguities should not compensate for the exponentially increased likelihood that parties would waste time and money on litigating this issue, as well as the increase in associated transaction costs.[214]

Second, as previously indicated, the split encourages forum shopping. Commentators have argued that forum shopping resulting from circuit splits is a problem that can produce economic inefficiencies because unpredictable

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[211] *Santander Holdings USA*, 844 F.3d 15, *cert. denied*, 137 S. Ct. 2295 (2017) (No. 16-1130).

[212] *See* Temkin, *supra* note 13, at 2 ("Absent Supreme Court review, the impacts of the economic substance doctrine on the ability of taxpayers to claim foreign tax credits will continue to be uncertain."); Wells Fargo & Co. v. United States, No. 09-CV-2764 PJS/TNL, 2017 U.S. Dist. LEXIS 150064 at *1 (D. Minn. Sept. 15, 2017). The U.S. District Court for the District of Minnesota's decision concluded the most recent case in Wells Fargo's long-running appellate saga in regards to its involvement in the STARS transaction. In the event that a petition for certiorari from Wells Fargo (or the United States) ever appears in front of the Supreme Court with respect to this case, it would be the first in the STARS / ADR line of cases in which the circuit court below (in this case, the Eighth Circuit) would have decided the fate of both the STARS and ADR transactions. The Supreme Court would, in that case, have to consider whether to resolve the issue of foreign taxes and their effects on pre-tax profit, or to continue to allow the divide between circuits, and possibly even within circuits, to grow.

[213] *See* Maxwell A. Miller, *Tax Litigation Primer*, 2 CORP. BUS. TAX'N MONTHLY 14, 15, 21 (2000) ("By its nature, tax litigation (like all litigation) involves conflicts over law or facts that can be intelligently argued either way, [and, in some cases] the law is written with such imprecision and ambiguity . . . that good faith arguments are possible on either side of the fence.")

[214] *See* Robert Bovarnick, *When is Litigation Worth the Hassle?*, FORBES (Jul. 21, 2010, 6:40 PM), https://www.forbes.com/2010/07/21/when-to-sue-entrepreneurs-law-taxation-bovarnick.html [https://perma.cc/ZGT9-73R9] ("Because the likelihood of victory [in litigation] lies somewhere south of 100%, we have to discount the potential spoils by some factor that captures the inherent risk of not winning the case. That means taking the likely award and multiplying it by some probability of success.").

legal outcomes make litigants unlikely to settle their cases.[215] Forum shopping also does a disservice to the administration of tax law. It can hardly be said that Congress wrote the foreign tax credit and economic substance doctrine provisions with the intent that the same transaction, performed by distinct groups of taxpayers who sue in different Circuits, should be treated differently by the IRS.[216] Furthermore, it does a disservice to tax planners and taxpayers in that larger, more affluent parties are more likely to be able to take advantage of the idiosyncratic results that the split provides, simply because they can afford to pay the transaction costs inherent in forum shopping. In this way, the split creates both vertical and horizontal inequality in the administration of the tax laws in question. And while there is a valid argument that the wealthier a client is, the more chances it has to avoid taxes it owes *because* of the availability of tax planners, it is not necessary for the courts to further exacerbate this gap by leaving open an additional loophole of their own creation.

The Supreme Court should not only grant review of this issue, but it should also resolve it using the STARS Circuit Courts' approach. In *Salem*, the Federal Circuit provided that it would be economically irrational to exclude the expense of foreign taxes when calculating profit potential in regards to the economic substance of foreign tax credit-producing transactions.[217] The Second and First Circuit followed the Federal Circuit's lead on the issue of calculating pre-tax profit. As a result, they likewise held that the STARS transaction lacked economic substance because it had no potential for generating a profit separate from the anticipated tax benefits when foreign tax expenses were taken into account, as they economically should.[218] The STARS Courts' approach is superior to that of the ADR Courts because it, as the STARS Courts have pointed out,[219] is grounded in economic reality and is supported by the language of Section 7701(o) of the Code as well as the intent of the economic substance doctrine more generally. Meanwhile, the ADR Courts' approach focuses too narrowly on the intent of Congress to avoid double taxation in implementing the foreign tax credit.

[215] *See generally* Kimberly A. Moore, *Forum Shopping in Patent Cases: Does Geographic Choice Affect Innovation?*, 79 N.C. L. REV. 889 (2001).

[216] *See* JOSEPH J. KLEIN, FEDERAL INCOME TAXATION 66, 74-75 (1929) (noting that the Supreme Court has consistently held that the Constitutional phrase "uniform throughout the United States," with respect to taxation, refers to geographical uniformity).

[217] *Salem Fin.*, 786 F.3d at 948.

[218] Temkin, *supra* note 13, at 2.

[219] *Santander Holdings USA*, 844 F.3d at 23 (citing *Salem Fin.*, 786 F.3d at 948) ("[W]e must 'assess [the] transaction's economic reality, and in particular its profit potential, independent of the expected tax benefits.'").

VIII. CONCLUSION

In conclusion, the circuit split on this issue is ripe for a successful appeal to the Supreme Court. The government's identification of the STARS transaction and the ADR transaction as potentially abusive tax shelters has made it unlikely that the transactions will continue to be marketed by tax planners or used by taxpayers.[220] However, the Supreme Court should address the issue of whether taxes paid to foreign governments should qualify as costs to be deducted in the calculation of pre-tax profit for the purposes of the economic substance doctrine because it is quite possible that this issue will arise again whenever the next foreign tax credit-generating transaction comes along. The Supreme Court should, at its next possible opportunity, grant certiorari on the issue so that it can resolve the conflict among the circuits for the benefit of taxpayers, tax planners, and the IRS.

Leaving this issue unresolved risks confusion and uncertainty for all parties. Tax planners that are unclear on the "rules" surrounding this issue may intuitively either take too aggressive or too conservative an approach. By extension, uncertain tax planners may result in uncertainty for their taxpaying clients, who may be disinclined to follow advice that they feel is not clearly supported by law. Additionally, the IRS may suffer from this lack of clarity in many ways, one major way being the volume of appeals that could arise on this issue going forward. Given that the U.S. decided long ago to take a hands-off approach to tax planning,[221] the courts should provide, where possible, clear direction on what they will and will not permit in that realm.

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[220] *See* Mark P. Gergen, *The Logic of Deterrence: Corporate Tax Shelters*, 55 TAX L. REV. 255, 255 (2001) ("[T]he government's current strategy for deterring corporate tax shelters can be effective. The strategy involves monitoring tax shelter activity, blacklisting new shelters when they are identified, and pursuing users of blacklisted shelters through promoters of the shelters along side more conventional audit techniques. [M]onitoring and enforcement can create a strong self-limiting dynamic in the corporate tax shelter market. If users and promoters of a tax shelter anticipate that government detection of a shelter will lead to a crackdown that potentially affects all users, they have a strong incentive to limit the volume of the shelter's distribution to reduce the risk of detection.").

[221] *See* Ordower, *supra* note 6, at 47.