

COMMENT: IS THE SHELTER A SHAM? AN ANALYSIS OF THE TREATMENT OF FOREIGN TAXES IN THE ECONOMIC SUBSTANCE DOCTRINE'S PRE-TAX PROFIT TEST

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ABSTRACT

The United States taxes all income earned by a taxpayer, regardless of its source. To prevent double taxation of income and to encourage international trade, Congress created the "Foreign Tax Credit," which allows a taxpayer to take a credit for any tax paid to another country on income earned abroad. This Comment discusses how the courts should apply the "pre-tax profit" test of the economic substance doctrine to challenge transactions where the taxpayer would incur a loss after paying foreign taxes, but a gain after applying the foreign tax credit.

The Internal Revenue Service (IRS) has challenged these transactions, arguing that they lack economic substance. To test for economic substance, the court uses a two-prong test called the "Economic Substance Doctrine." The first prong, commonly called the "pre-tax profit" test, asks if the transaction had a possibility of a profit absent tax consequences. The second prong, commonly called the "Business Purpose" test, asks if the transaction has a non-tax business purpose that furthers the taxpayer's economic position. If one of the prongs is met, the transaction will usually be found to be legitimate, and the foreign tax credit will be granted.

A circuit split has developed regarding whether foreign taxes should be factored into calculating profit with respect to the pre-tax profit test. The United States Court of Appeals for the Fifth and Eighth Circuits hold taxes paid to a foreign country should be excluded from the test because factoring them in would "stack the deck" against finding the transaction legitimate. The United States Court of Appeals for the First, Second and Federal Circuit hold otherwise, arguing that foreign taxes should be treated as an expense of the transaction because doing so more accurately reflects the taxpayer's change in economic position.

The correct approach is that of the First, Second, and Federal Circuits. By including foreign taxes paid as an expense of the transaction, the court remains consistent with the language of the codified economic substance doctrine, and with the underlying policies of the foreign tax credit. Including foreign taxes in the determination of profit more accurately assesses whether the transaction meaningfully changed the taxpayer's net economic position, and furthered international trade. Since a taxpayer must pay tax on its foreign income to at least one country, the amount of the tax is implicit in the transaction. Since a prudent investor is assumed to consider those tax effects when estimating the profitability of a venture, a test

that considers foreign taxes as an expense of the transaction more accurately reflects the net change in the taxpayer's economic position. If a prudent investor would not invest in the transaction without the tax benefits that it generates, then the transaction is likely a shelter, and is not the type that Congress intended to encourage by granting the foreign tax credit.

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"[A] taxpayer who attempts to apply the foreign tax credit rules in other than the simplest of contexts may find himself hopelessly confused."¹

I. INTRODUCTION

At the time of writing this Comment, the top federal marginal tax rate was

1. 1-12 Rhoades & Langer, U.S. Int'l Tax'n & Tax Treaties § 12.02 (2017).

35%.² At that rate, the United States had the third highest top marginal corporate tax rate in the world.³ Effective January 1st, 2018, The Tax Cuts and Jobs Act lowered the corporate tax rate to 21%.⁴ While this generous cut should lower tax liability for many US corporations, these entities will continue to take advantage of the credits and deductions available to them under the Internal Revenue Code to realize effective tax rates that are much lower than the marginal rate.⁵

This Comment discusses a very specific type of strategy where a corporation will use foreign entities and the foreign tax credit to take advantage of lower international tax rates and lower its overall US tax liability. Some of these transactions involve corporations that have successfully obtained loans from foreign companies at lower than market interest rates by helping a foreign lender take advantage of differences between its code and the Internal Revenue Code.⁶ Further, this Comment explains a recently emerged circuit split where the courts have struggled to distinguish legitimate transactions from those that abuse the foreign tax credit to generate substantial unrelated tax benefits to the taxpayer, and provides a recommendation as to how courts should treat these tax shelters in a manner consistent with both the economic substance doctrine, and congressional mandate.

To begin, the United States taxes income earned "from whatever source derived,"⁷ and income earned abroad counts as taxable income for any domestically

2. 26 U.S.C. § 11(b)(1)(D) (2012). The top federal marginal rate for corporations in the United States was 35% and the average state corporate rate is an additional 3.92%. *Id.*; see also *Corporate Income Tax Rates Around the World, 2016*, TAX FOUND. (Aug. 18, 2016), <http://taxfoundation.org/article/corporate-income-tax-rates-around-world-2016>. KPMG, one of the "big four" accounting firms, estimates the average net effective rate at around 40%, finding that the average top marginal rate at the state level is 7.5%, and together (federal & state) the total aggregate tax rate is slightly lower because portions of the taxes paid to a state government may be deducted by the corporation when calculating its federal taxable income. *Corporate Tax Rates Table*, KPMG, <https://home.kpmg.com/xx/en/home/services/tax/tax-tools-and-resources/tax-rates-online/corporate-tax-rates-table.html> (last visited Nov. 10, 2017).

3. TAX FOUND., *supra* note 2.

4. 26 U.S.C. § 11(b) (West 2018). Section 13001 of the Tax Cuts and Jobs Act of 2017 reads, "The amount of the tax imposed by subsection (a) shall be 21 percent of taxable income." The Tax Cuts and Jobs Act of 2017, 115 P.L. 97, 131 Stat. 2054 (West 2017).

5. *Fact Sheet: Corporate Tax Rate*, AM. FOR TAX FAIRNESS, <https://americansfortaxfairness.org/tax-fairness-briefing-booklet/fact-sheet-corporate-tax-rates/> (last visited Feb. 16, 2018). The effective tax rate is the percentage of the taxpayer's out-of-pocket expense relative to its taxable income. *Effective Tax Rate*, INVESTOPEDIA, <https://www.investopedia.com/terms/e/effectivetaxrate.asp> (last visited Feb. 16, 2018). Generally, the effective tax rate is lower than the statutory rate because of permanent differences between book and tax income. For instance, for Fiscal Year 2016, Starbucks had an effective tax rate of 32.9% (this included a tax expense of \$1.379 billion on a taxable income of \$4.198 billion). Starbucks Corp., Fiscal 2016 Annual Report (Form 10-K) 25 (Oct. 2, 2016), https://s22.q4cdn.com/869488222/files/doc_financials/annual/2016/FY16-Annual-Report-on-Form-10-K.pdf.

6. See generally Kevin Dolan, *The Foreign Tax Credit Diaries – Litigation Run Amok*, TAX NOTES INT'L 831 (Aug. 26, 2013), <https://www.taxnotes.com/tax-notes-international/foreign-source-income/foreign-tax-credit-diaries-litigation-run-amok/2013/08/26/sgy7>.

7. 26 U.S.C. § 61(a) (2012). See also INTERNAL REVENUE SERV., U.S. DEP'T TREASURY, PUB. NO. 525, TAXABLE AND NONTAXABLE INCOME 2 (2016), <https://www.irs.gov/pub/irs-pdf/p525.pdf>.

based corporation.⁸ Thus, foreign income is also subjected to US income tax rates.⁹ Absent a mechanism to exclude this income, corporations would be hit with a double tax — a tax in the country where it was earned, and another tax in the United States. This otherwise severely restricts international trade and provides a disincentive to engage in any business that would produce income in other countries. Further, it encourages a corporation to place its headquarters and capital in a country that has the lowest corporate tax rate.¹⁰

To prevent this, Congress created the foreign tax credit.¹¹

II. THE FOREIGN TAX CREDIT

Under section 901 of the Internal Revenue Code, a citizen or corporation can take a dollar for dollar credit on its tax liability for any tax already paid to a foreign country on that same income.¹² This is, in essence, the Foreign Tax Credit.¹³ For example, imagine if Company A, a corporation based in the United States, decides to open an office in the United Kingdom. During its first year of operation in the UK, Company A earns \$1 million in profits. The UK government will assess a 20% tax, approximately, on that income.¹⁴ Thus, Company A will pay \$200,000 in taxes to the United Kingdom. However, because the United States taxes income earned “from whatever source derived,” Company A will be required to report the same \$1 million as taxable income to the US government.¹⁵ The IRS will then assess a tax at the 21% top marginal rate.¹⁶ Fortunately, to avoid this draconian outcome, the IRS will allow Company A to take a credit for the amount already paid in taxes to the United Kingdom.¹⁷

Unlike deductions, credits are a dollar for dollar reduction in the tax liability of a taxpayer.¹⁸ In other words, a tax credit provides a greater tax benefit than a tax deduction. Figure 1 below details the difference between taking a credit and taking a deduction using the example of Company A.

8. See 26 U.S.C. § 7701(a)(4). A “domestic” corporation is defined as any entity “created or organized in the United States or under the law of the United States or of any State.” *Id.*

9. See *id.*

10. BORIS I. BITTKER & JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶15.20[1][a] (Warren Gorham & Lamont, 7th ed. 2000 & Supp. 2015).

11. “The [foreign tax credit] provision was originally designed to produce uniformity of tax burden among United States taxpayers, irrespective of whether they were engaged in business in the United States or engaged in business abroad.” *Santander Holdings USA, Inc. v. United States*, 844 F.3d 15, 17 (1st Cir. 2016) (citing H.R. REP. NO. 83-1337, at 4103 (1954)).

12. 26 U.S.C. §§ 901(a)–(b)(1).

13. See *id.* §§ 901–910 (further expanding the limitations and allowances of the foreign tax credit).

14. *Corporate Tax Rates and Reliefs*, U.K. GOV’T, <https://www.gov.uk/corporation-tax-rates/rates> (last visited Feb. 21, 2018). The 2016 corporate tax rate in the United Kingdom is 20%. *Id.* However, the transactions discussed in this Comment occurred when the corporate tax rate was 30%.

15. 26 U.S.C. § 61(a). See also INTERNAL REVENUE SERV., *supra* note 7.

16. *Id.* § 11(b).

17. JANE G. GRAVELLE, CONG. RESEARCH SERV., R41743, INTERNATIONAL CORPORATE TAX RATE COMPARISONS AND POLICY IMPLICATIONS 10 (2014).

18. See 26 U.S.C. § 901(a).

	<u>Deduction</u>	<u>Credit</u>
Company A Income (Earned Abroad)	\$1,000,000	\$1,000,000
- (Deduction) UK Taxes Paid	(\$200,000)	-
<hr/>		
Taxable Income	\$800,000	\$1,000,000
x 21% US Tax Rate	x 21%	x 21%
<hr/>		
US Tax Liability (Pre-Credits)	\$168,000	\$210,000
- (Credit) UK Taxes Paid	-	\$200,000
US Tax Liability (Post-Credits)	\$168,000	\$10,000

Figure 1 – The Effects of a Deduction vs. a Credit on Tax Liability

As mentioned, the main purpose of the foreign tax credit is to prevent the “double taxation” of income.¹⁹ If the IRS did not allow a foreign tax credit, Company A would pay \$200,000 to the United Kingdom and another \$168,000 to the United States on the same income.²⁰ If Congress permitted a foreign tax deduction instead of a foreign tax credit, Company A would pay \$200,000 to the United Kingdom and an additional \$168,000 to the United States, effectively paying 36.8% in taxes to do business in the UK.²¹ By allowing a credit, Congress has avoided the double tax problem. Instead, Company A is only required to pay the difference between any tax owed to the United States and any tax already paid to the United Kingdom; since Company A had already paid \$200,000 to the UK, it will only owe the remaining \$10,000 to the US.²²

Furthermore, by preventing double taxation, Congress is helping to “facilitate business abroad and foreign trade.”²³ Absent the credit, Company A is penalized for engaging in international business because it ends up paying more tax than if it had made the same income domestically. By allowing the credit, Company A can freely choose where it would like to do business. But, by carefully choosing where to do business, some corporations find ways to take advantage of differences in foreign tax codes to create a tax shelter.

A tax shelter is a transaction that is designed to reduce a taxpayer’s tax liability by an amount greater than its cost.²⁴ Tax shelters that use the foreign tax credit generally follow a similar structure.²⁵ A tax paying entity will subject itself to foreign

19. *Bank of N.Y. Mellon Corp. v. Comm’r*, 801 F.3d 104, 107 (2d Cir. 2015) (citing *Burnet v. Chi. Portrait Co.*, 285 U.S. 1, 7 (1932)).

20. *See supra* Figure 1.

21. *Id.* This is calculated by adding the tax bill of each country and dividing by the income earned: $(\$200,000 + \$168,000) / \$1,000,000 = \$368,000 / \$1,000,000 = 36.8\%$.

22. The \$10,000 results from the difference between the UK’s 20% corporate tax rate, and the United States’ 21% rate: $(\$1 \text{ million} \times (21\% - 20\%)) = \$1 \text{ million} \times 01\% = \$10,000$.

23. *Bank of N.Y. Mellon Corp.*, 801 F.3d at 104.

24. *What Are Tax Shelters?*, TURBOTAX, <https://turbotax.intuit.com/tax-tools/tax-tips/Taxes-101/What-Are-Tax-Shelters-/INF15381.html> (last visited Feb. 16, 2018).

25. *See generally* *IES Indus. v. United States*, 253 F.3d 350 (8th Cir. 2001); *Bank of N.Y. Mellon Corp.*, 801 F.3d at 110.

taxes, enter a transaction that would otherwise not be profitable absent the tax consequences, and then use the capital losses, interest deductions, and foreign tax credits generated by the transaction to offset its current US tax liability. While technically legal within the black letter meaning of the code, the IRS has not taken kindly to these arrangements.²⁶ In the IRS and Tax Court's view, there must be a valid purpose for the transaction in order to take the credit.²⁷ A transaction will not be valid "if it is fictitious or if it has no business purpose or economic effect other than the creation of tax deductions."²⁸ The IRS has shown that it will scrutinize and challenge any transaction that is designed to only generate foreign tax credits. Thus, to prevent these types of sham transactions, and other similar shelter-like arrangements, the courts have employed a common-law test (now codified) known as the economic substance doctrine.²⁹

III. THE ECONOMIC SUBSTANCE DOCTRINE

The economic substance doctrine began as a common-law doctrine that tested the validity of a transaction by asking if it had economic substance independent of any tax consequences.³⁰ The doctrine is now codified in I.R.C. section 7701(o).³¹

I.R.C. section 7701(o)(1) largely retains the language and purpose of the common-law test. As discussed below, section 7701(o)(2) includes some additional clarification that provides evidence of Congress's intent to treat foreign income tax paid as an expense.³² However, most of the transactions discussed in this Comment arose prior to the economic substance doctrine's codification. Thus, a brief introduction of the common-law elements of the test is necessary.

26. See generally *IES Indus.*, 253 F.3d 350 (8th Cir. 2001); *Bank of N.Y. Mellon Corp.*, 801 F.3d at 110.

27. *Bank of N.Y. Mellon Corp.*, 801 F.3d at 108 (citing 12 METENS LAW OF FEDERAL INCOME TAXATION § 45D:62).

28. *DeMartino v. Comm'r*, 862 F.2d 400, 406 (2d Cir. 1988) (citing *Sochin v. Comm'r*, 843 F.2d 351, 354 (9th Cir. 1988)).

29. The economic substance doctrine is now codified in 26 U.S.C. § 7701(o) (2012).

30. The economic substance doctrine was crafted in the Supreme Court's decision in *Gregory v. Helvering*, where the court held that a corporate reorganization was invalid because it lacked economic substance despite complying with the Code. See 293 U.S. 465 (1935). The court further refined the doctrine in *Frank Lyon Co. v. United States* by holding 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 and duties effectuated by the parties.

435 U.S. 561, 583–84 (1978).

31. The doctrine was codified in 2010 by the Health Care and Education Reconciliation Act of 2010. See I.R.S. Notice 2010-62, <https://www.millerchevalier.com/sites/default/files/resources/Notice2010-62.pdf>; 26 U.S.C. § 7701(o) (West 2017).

32. See *id.* § 7701(o)(2) (Westlaw) (discussing special rules where a taxpayer relies on the "pre-tax profit" prong of the economic substance doctrine).

At common law, the economic substance doctrine has two prongs: an objective “pre-tax profit” test and a subjective “business purpose” test.³³ The first prong, the objective prong, more commonly called the “pre-tax profit” test, asks if the transaction had a possibility of profit.³⁴ It requires that “the transaction changes in a meaningful way (apart from Federal Income tax effects) the taxpayer’s economic position[.]”³⁵ In other words, the test asks if after all transaction costs and other related expenses, the business would have earned a profit and be in a better economic position than if it had not entered the transaction.

However, using only an objective profit test is not sufficient to find that a transaction has economic substance. If only the objective profit test were used, transactions that incur a cost, but change the taxpayer’s economic position would be deemed invalid because the taxpayer would have no profit. This category of transactions might include those where the taxpaying corporation has made some income, and increased its equity from benefits derived during the research and development phase, but has not yet finished a marketable, profitable product or service. Often in pharmaceutical and engineering fields, a corporation can go through its first several years with a new product without yet making a profit.³⁶ Under the objective prong alone, these companies would not be able to take a foreign tax credit for any income already taxed because they did not yet make a profit on their venture.

To resolve this, the court employs a second test. Under the second prong of the economic substance doctrine, the court asks if the transaction has a non-tax business purpose.³⁷ This test looks at the corporation’s motivations for entering the transaction. If there is no motivation other than acquiring tax benefits, the court will likely find the transaction was a tax shelter.³⁸ The question the court asks is: does the taxpayer have a “substantial purpose . . . for entering into such [a] transaction[?]”³⁹

The Court has acknowledged that the economic substance doctrine is not a “rigid two-[part] analysis.”⁴⁰ Courts differ on how to apply the test.⁴¹ While both prongs are considered, each only serve as a factor to inform the court as to whether the transaction had economic substance and should be respected. For the purposes

33. Bank of N.Y. Mellon Corp. v. Comm’r, 801 F.3d 104, 115 (2d Cir. 2015).

34. *Id.* at 116.

35. 26 U.S.C. § 7701(o)(1)(A) (Westlaw).

36. Transactions involving nascent technologies, for instance, often do not turn a profit in the early years unless tax benefits are accounted for. To brand such transactions as a sham simply because they are unprofitable before tax benefits are taken into account would be contrary to the clear intent of Congress.

Salem Fin., Inc. v. United States, 786 F.3d 932, 950 (Fed. Cir. 2015) (citing *Sacks v. Comm’r*, 69 F.3d 982, 990–92 (9th Cir. 1995)).

37. *Rice’s Toyota World, Inc. v. Comm’r*, 752 F.2d 89, 91 (4th Cir. 1985).

38. *Bank of N.Y. Mellon Corp.*, 801 F.3d at 119.

39. 26 U.S.C. § 7701(o)(1)(B) (West 2017).

40. *Compaq Comput. Corp. v. Comm’r*, 277 F.3d 778, 781 (5th Cir. 2001) (citing *James v. Comm’r*, 899 F.2d 905, 908–09 (10th Cir. 1990)).

41. *Compaq Comput. Corp.*, 277 F.3d at 781–82.

of this Comment, the relevant test at issue is the objective “pre-tax profit” test. However, some of the cases discussed below rely on both prongs of the economic substance doctrine to justify their holdings.⁴² Thus, where appropriate, the subjective “business-purpose” prong is used to supplement a holding when the objective prong alone cannot.

IV. THE CIRCUIT SPLIT

Currently, there is a circuit split regarding how foreign taxes should be treated with respect to the objective prong of the economic substance doctrine.⁴³ The debate centers on whether the pre-tax profit test should consider taxes paid to a foreign country as a cost of the transaction, and thus an “expense”, or if it should exclude such taxes as a “tax”.⁴⁴ If taxes paid to a foreign country are treated merely as an expense, then the court should consider whether a taxpayer had a profit after foreign tax but before United States tax. If taxes paid to a foreign country are treated as a tax, the court would instead consider whether a taxpayer had a profit before it paid any taxes, including taxes paid to foreign countries.

The United States Court of Appeals for the Fifth and Eighth Circuits have held that foreign taxes should not be considered an expense, and thus, should be excluded from the pre-tax profit test.⁴⁵ Meanwhile, the United States Court of Appeals for the First, Federal, and Second Circuits, while analyzing a different kind of transaction, have held that tax incurred abroad is an expense of the transaction, and should be factored into the pre-tax profit test.⁴⁶ To analyze the various approaches, it is first necessary to understand the transactions at play.

A. The Fifth and Eighth Circuits Find That Foreign Taxes Should not be Treated as Economic Costs with Respect to the Pre-Tax Profit Test.

The Fifth and Eighth Circuit were the first to weigh in on the treatment of foreign taxes in the pre-tax profit test.⁴⁷ Both courts held that foreign taxes should not be treated as an expense in the determination of profit because the purpose of the test is to assess profitability absent tax consequences, and foreign taxes count as “tax consequences.”⁴⁸

The transactions analyzed by the Fifth and Eighth Circuits involved domestic

42. See, e.g., *id.* at 780–82.

43. Compare *Compaq Comput. Corp.*, 277 F.3d 778, and *IES Indus., Inc. v. United States*, 253 F.3d 350 (8th Cir. 2001) (holding that foreign taxes should be treated as a tax, and thus should be excluded when calculating pre-tax profit with respect to the objective prong of the economic substance doctrine), with *Bank of N.Y. Mellon Corp. v. Comm’r*, 801 F.3d 104 (2nd Cir. 2015), and *Salem Fin., Inc. v. United States*, 786 F.3d 932 (Fed. Cir. 2015), and *Santander Holdings USA, Inc. v. United States*, 844 F.3d 15 (1st Cir. 2016) (holding that foreign taxes should be treated as an expense, and thus should be factored into the determination of pre-tax profit with respect to the objective prong of the economic substance doctrine).

44. See *supra* note 43 and accompanying text.

45. *Compaq Comput. Corp.*, 277 F.3d at 788; *IES Indus., Inc.*, 253 F.3d at 356.

46. *Bank of N.Y. Mellon Corp.*, 801 F.3d at 122; *Salem Fin., Inc.*, 786 F.3d at 951; *Santander Holdings USA, Inc.*, 844 F.3d at 26.

47. See *Compaq Comput. Corp.*, 277 F.3d 778; see also *IES Indus. Inc.*, 253 F.3d 350.

48. *Compaq Comput. Corp.*, 277 F.3d at 788; *IES Indus. Inc.*, 253 F.3d at 356.

corporations purchasing and selling stock in a foreign company.⁴⁹ The primary purpose for the purchase was to obtain a dividend while simultaneously generating a capital loss that could be used to offset other short-term capital gains recognized in previous separate transactions.⁵⁰

In both cases, the transaction began with a proposal by an investment firm called Twenty-First Securities Corporation.⁵¹ The proposed transaction, typically called an “ADR transaction” or a “dividend stripping transaction,” involved the purchase of a negotiable certificate called an American Depository Receipt, or “ADR.”⁵² An ADR is a certificate issued by a US bank that represents one or more shares of a foreign corporation.⁵³ ADRs are traded on US stock exchanges, and holders of ADRs realize the same dividends and capital gains as if they were holders of the actual shares.⁵⁴

i. Fifth Circuit: *Compaq Computer Corp. v. Commissioner*

In *Compaq Computer Corp. v. Commissioner*, the Fifth Circuit analyzed an ADR transaction in which Compaq entered an agreement with Twenty-First Securities Corporation to purchase ten million ADRs of the Royal Dutch Petroleum Company, commonly known as “Royal Dutch Shell” or “Shell” for short.⁵⁵ Shell had recently declared a dividend, and Compaq wished to be the owner of the stock on the date of record to receive the dividend income.⁵⁶ In just over an hour, Twenty-First Securities made 46 New York Stock Exchange transactions comprising 23 purchases of about 450,000 ADRs each and 23 simultaneous resales of the same stock.⁵⁷ This purchase and resale is known as a “dividend stripping transaction” because the goal of the transaction is to only get the dividend and not to hold the stock as an investment. As discussed further below, the resulting benefit to the company depends on having US capital gains from earlier events that can be offset by the tax losses generated by the dividend stripping transactions.

49. *Compaq Comput. Corp.*, 277 F.3d at 779–80; *IES Indus. Inc.*, 253 F.3d at 351–52.

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

51. *Compaq Comput. Corp.*, 277 F.3d at 779; *IES Indus. Inc.*, 253 F.3d at 352.

52. *Compaq Comput. Corp.*, 277 F.3d at 779.

53. *American Depository Receipt – ADR*, INVESTOPEDIA, <http://www.investopedia.com/terms/a/adr.asp> (last visited Feb. 21, 2018). An American Depository Receipt (ADR) exists to make it easier for American investors to purchase shares in non-U.S. listed companies. *Id.* Prior to ADRs, American investors had to buy such shares on international exchanges, which could cause exchange rate issues, and “regulatory differences.” *Id.*

54. *Id.*

55. *Compaq Comput. Corp.*, 277 F.3d at 779–80.

56. *Id.* at 780. See also Jean Folger, *Introduction to Dividends: Dividend Dates*, INVESTOPEDIA, <http://www.investopedia.com/university/introduction-to-dividends/dividend-dates.asp> (last visited Feb. 21, 2018). The date of record is the day that a company determines to whom they owe a dividend. *Id.* A shareholder must be on the “company’s books” on the date of record to receive a dividend payment. *Id.* The date of record follows the declaration date, and is usually announced as part of the declaration statement. *Id.*

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

The purchase transactions were settled before the date of record, and the resale transactions had a settlement date after the date of record to ensure that Compaq was the registered owner when Shell determined whom to pay.⁵⁸ The purpose of the purchase and simultaneous resale was to capture the dividend but minimize the risk that the market price would change significantly, or that any of the trades would be broken up on the trading floor.⁵⁹ Figure 2 below illustrates the timeline of the purchase, sale, and settlement dates.

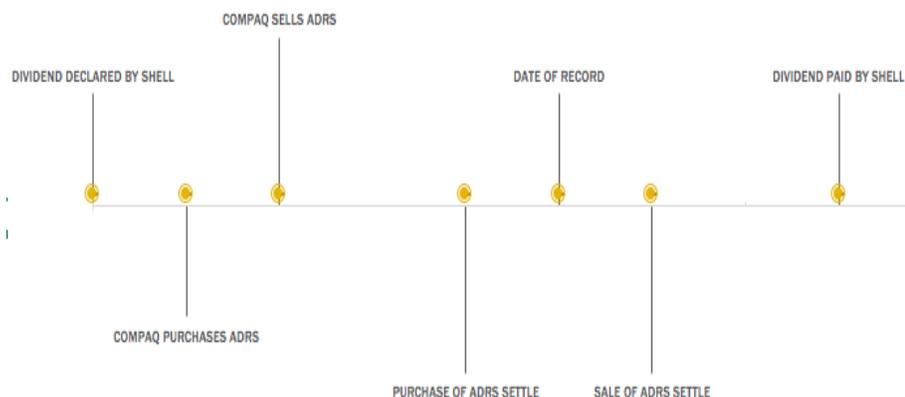


Figure 2 – General Timeline of the Purchase and Resale of ADRs in Compaq Computer Corp.

Compaq paid approximately \$887.6 million for the stock “cum dividend,”⁶⁰ and received approximately \$868.4 million on the sale “ex-dividend.”⁶¹ Thus, Compaq realized a short-term capital loss of approximately \$19.2 million.⁶² Additionally, Compaq used a margin account with Bear Stearns & Co., Inc., the clearing broker for the transaction, and paid \$1.5 million in commissions, margin account interest, and fees.⁶³ In total, the overall loss before taxes was \$20.7 million.⁶⁴ The resulting gross dividend was approximately \$22.5 million.⁶⁵ Therefore, before taxes, Compaq would have had a profit of \$1.8 million.⁶⁶ However, since the dividend is income, about \$3.3 million in tax was withheld and paid to the Netherlands government,

58. *Id.* at 779; *See generally* *Compaq Comput. Corp. v. Comm’r*, 113 T.C. 214, 217 (1999) (the purchases formally settled on September 17, 1992 per “next-day” settlement terms in New York Stock Exchange rule 64, and the resales were settled on September 21, 1992 per the standard settlement term of 5 days).

59. *Compaq Comput. Corp.*, 277 F.3d at 787.

60. *Id.* at 780 (“Cum dividend” refers to the stock with the right to the dividend payment still attached).

61. *Id.* (“Ex-dividend” refers to the stock with the right to the dividend payment already exercised, and thus no longer attached to it).

62. *Id.*

63. *Id.*; *Compaq Comput. Corp.*, 113 T.C. at 216–17.

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

65. *Id.*

66. This is calculated by taking the total dividend income less the cost of the transaction before foreign taxes. Thus, \$22.5 million less \$20.7 million yields a profit of \$1.8 million.

resulting in a net dividend of about \$19.2 million.⁶⁷ Thus, Compaq realized a loss and paid approximately \$1.5 million for the transaction.⁶⁸ On its income tax return, Compaq reported \$20.7 million in capital losses from the resale, \$22.5 million in dividends, and a foreign tax credit for the \$3.3 million paid in Dutch tax.⁶⁹ Figure 3 below details the calculation.

	In Millions \$
Purchase of Stock "Cum dividend"	(887.6)
+ Sale of Stock "Ex dividend"	868.4
- Commissions, Margin Account Interest, and Fees	(1.5)
Short Term Capital Loss on Purchase and Resale	(20.7)
+ Dividend Income	22.5
Pre-Foreign Tax Profit	1.8
- Netherlands Tax	(3.3)
Pre-US Tax Loss	\$(1.5)

Figure 3 – Calculation of Pre-Tax Profit in Compaq Computer Corp.

Normally it does not make economic sense for a corporation to enter into a transaction if was going to realize an overall \$1.5 million loss. However, since Compaq paid \$3.3 million in tax to the Netherlands, it can claim a foreign tax credit on its US income tax bill. This is beneficial because credits directly reduce a taxpayer's tax liability, dollar for dollar.⁷⁰ A credit is worth the same amount in all tax brackets because it applies directly to a taxpayer's bill, and not taxable income.⁷¹ Thus, to assess the benefits of Compaq's purchase and sale of Royal Dutch shares, all the tax effects must first be realized in actual dollars.

To begin, since the foreign tax credit is already in actual dollars, it remains at \$3.3 million.⁷² Next, using the capital gains rate of 15%,⁷³ the \$20.7 million in capital losses that Compaq used to offset capital gains gave Compaq another \$3.1 million in tax benefit. This is because Compaq was relieved from having to pay taxes on \$20.7 million in gains it had already incurred and would have normally had to pay. As a result, for the \$1.5 million total loss on the transaction, Compaq realized a net benefit of approximately \$6.4 million off its potential tax bill.

67. *Compaq Comput. Corp.*, 113 T.C. at 219.

68. *See infra* Figure 3.

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

70. *Foreign Tax Credit*, IRS, <https://www.irs.gov/individuals/international-taxpayers/foreign-tax-credit> (last updated Nov. 27, 2017).

71. *Id.*

72. No adjustment is necessary because the 3.3 million is a credit (dollar-for-dollar).

73. *See* 26 U.S.C. § 1 (West 2017).

	<u>\$ Million</u>		<u>Capital Gains Rate</u>	<u>Effective Tax Benefit</u>
Relief of Capital Gains (offset by the Capital Loss)	\$20.7	x	15.0%	\$3.1
Foreign Tax Credit	\$3.3		-----	\$3.3
	Total Tax Benefit			\$6.4 mil

Figure 4 – Calculation of Total Tax Benefit to Compaq.

After Compaq filed its 1992 tax return, the Commissioner of the IRS sent a notice of deficiency to Compaq citing the ADR transaction.⁷⁴ Compaq petitioned the Tax Court for a redetermination of the deficiencies,⁷⁵ and the Tax Court found that Compaq failed both prongs of the economic substance test.⁷⁶ First, under the objective “pre-tax profit” test, the court argued that the transaction did not have any expectation of a pre-tax profit because the Dutch taxes exceeded the profit from the dividend.⁷⁷ To come to this conclusion, the court factored the foreign taxes paid to the Dutch government but did not factor US income tax consequences.⁷⁸ Second, under the subjective “business purpose” test, the Court found that Compaq had “no business purpose for the purchase and sale of Royal Dutch ADR’s apart from obtaining a Federal income tax benefit in the form of a foreign tax credit while offsetting the previously recognized capital gain.”⁷⁹

While the Tax Court found that the transaction was a sham, on appeal the Fifth Circuit found otherwise.⁸⁰ The Fifth Circuit held that the part of the dividend withheld as taxes was just as much income as the amount remaining after taxes.⁸¹ It concluded that the Tax Court erred by including only the \$3.4 million paid in taxes because the purpose of the economic substance doctrine is to assess the economic substance of a transaction absent tax consequences, and the inclusion of the foreign taxes paid would violate that purpose.⁸² Thus, the Fifth Circuit held that if the effects of tax law, domestic or foreign, are to be accounted for when they subtract from a transaction’s net cash flow, tax law effects should be counted when they add to cash flow.⁸³ “To be consistent, the analysis should either count all tax law effects or not count any of them.”⁸⁴

In making this determination, the Court cited *Old Colony Trust Co., v. Comm’r*, a pivotal tax case where an employer paid an employee’s income tax on his behalf, and the Supreme Court held that “[t]he discharge by a third person of an obligation

74. *Compaq Comput. Corp. v. Comm’r*, 277 F. 3d 778, 780 (5th Cir. 2001).

75. *Id.*

76. *Id.* at 782.

77. *Compaq Comput. Corp. v. Comm’r*, 113 T.C. 214, 223–24 (1999).

78. *Compaq Comput. Corp.*, 277 F.3d at 782.

79. *Compaq Comput. Corp.*, 113 T.C. at 220.

80. *Compaq Comput. Corp.*, 277 F.3d at 788.

81. *Id.* at 783.

82. *Id.* at 785.

83. *Id.*

84. *Id.*

to him is equivalent to receipt by the person taxed.”⁸⁵ Thus, the amount of tax paid by the employer on behalf of the employee was also considered to be income to the employee.⁸⁶ Here, the Fifth Circuit found that, under the same principle, Compaq was entitled to the gross income of the dividend, not just the net income, because it did not matter whether the tax originated in a foreign country, or that the taxes were withheld by the Dutch government prior to payment to Compaq.⁸⁷

The Court further argued that counting taxes only when “they subtract from cash flow is to stack the deck against finding the transaction profitable.”⁸⁸ Thus, it concluded that, by applying either all or none of the tax effects of the transaction, Compaq made both a pre-tax profit and an after-tax profit from the transaction.⁸⁹

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

In a nearly identical type of transaction, the Eighth Circuit also weighed in on the treatment of foreign taxes in the pre-tax profit test in *IES Industries, Inc. v. United States*.⁹⁰ As in *Compaq*, the transaction in *IES* involved a dividend stripping “ADR transaction.”⁹¹ *IES Industries*, an energy company, employed a broker to find ADRs subject to a dividend.⁹² The broker would find ADRs owned by tax-exempt entities that could not take advantage of the foreign tax credit, and then transact with a third party to have the third party “short” the ADRs to *IES*.⁹³ Like *Compaq*, *IES* was interested in these ADRs so that it could be the owner on the date of record.⁹⁴ *IES* would purchase the ADRs for market value plus 85% of the expected dividend.⁹⁵ The 85% was calculated as the amount the lender would have received had it kept the stock for itself because the dividend income would be subject to 15% capital gains tax.⁹⁶

In 1991 and 1992, as a result of these transactions, *IES* reported gross dividend

85. 279 U.S. 716, 729 (1929).

86. *Id.*

87. *Compaq Comput. Corp.*, 277 F.3d at 784.

88. *Id.* at 785.

89. *Id.* at 786.

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

91. *Id.* at 352.

92. *Id.*

93. *Id.* *See also* Philip Van Doorn, *Opinion: Why You Should Never Short-Sell Stocks*, MARKETWATCH (Nov. 27, 2015), <https://www.marketwatch.com/story/why-you-should-never-short-sell-stocks-2015-11-19>. To “short” a stock, in this case, is to borrow the stock for a small fee, temporarily sell it subject to the dividend, and then re-purchase the stock post-dividend to recognize a quick short-term gain. *Id.* Then, the borrower gives the original stock back. Essentially, a “short” is a bet that the price of a security will go down. *Id.* So, the borrower will pay a small interest fee to borrow another shareholder’s stock so that she can capitalize on the downward change in price. *Id.* When she repurchases the stock, she is hoping to buy it back for a cheaper price. *Id.*

94. *IES Indus. Inc.*, 253 F.3d at 352.

95. *Id.*

96. *Id.*

income of approximately \$90.8 million.⁹⁷ IES paid over \$13.5 million to foreign countries in tax assessed on the dividend income.⁹⁸ Since IES incurred losses selling the stock ex-dividend, it recognized capital losses of more than \$82.7 million, which was used to offset capital gains earned in 1989 and 1990.⁹⁹ IES also conducted most of the transactions on a margin account (using borrowed funds) and thus could deduct the \$3.1 million in interest paid on the account.¹⁰⁰ Figure 5 below details the calculation.

	In Millions
Short Term Capital Loss on Purchase and Resale	\$ (82.7)
+ Dividend Income	90.8
Pre-Foreign Tax Profit	8.1
- Netherlands Tax	(13.5)
Pre-US Tax Loss	\$ (5.4)

Figure 5 – Calculation of Pre-tax Profit in *IES Indus. v. Comm’r*

As in *Compaq*, the benefits to IES were worth the cost. Again, credits are dollar for dollar.¹⁰¹ Thus, IES would not have to worry about double taxation if it could take the foreign tax credit. So, it had the incentive to enter the transaction if the net tax benefits were greater than the cost. Here, IES took the capital loss of \$82.7 million to offset other capital gains.¹⁰² By offsetting those gains, IES did not have to pay taxes on that income.¹⁰³ Thus, the net realized tax benefit to IES was \$12.405 million.¹⁰⁴ Since the overall net cost of the transaction was only \$5.4 million, IES benefitted from the transaction by about \$7 million.¹⁰⁵

While IES paid \$13.5 million to cover the tax bill on \$90.8 million of capital gains from the dividend, it sold the stock back for \$82.7 million.¹⁰⁶ IES made a profit on the dividend of about \$8.1 million.¹⁰⁷ This is the pre-tax profit. Without considering any other tax consequences, the transaction would pass the pre-tax profit test because an actual profit was made. But, since \$13.5 million was paid in foreign taxes, the total economic change was a loss of \$5.4 million. If the court were to consider foreign tax consequences as an expense and factor it into the pre-tax profit test, IES would not pass. The benefits would have only accrued to IES if the court

97. *Id.*

98. *Id.* at 353.

99. *Id.*

100. *IES Indus. Inc.*, 253 F.3d at 353.

101. 26 U.S.C. §§ 901(a)–(b)(1) (West 2017).

102. *IES Indus. Inc.*, 253 F.3d at 353.

103. *Id.*

104. *See id.* The amount that IES was relieved from paying is calculated by finding what the tax on \$82.7 million in capital gains would have been. At a 15% capital gains rate, the amount would have been \$12.405 million (\$82.7 million * 15% = \$12.405 million).

105. This is calculated by netting the approximate tax benefit to IES of \$12.405 million against the cost of the transaction at only \$5.4 million.

106. *IES Indus. Inc.*, 253 F.3d at 353.

107. *See id.* at 352–53. \$90.8 million of dividend income less the \$82.7 million in capital losses yields about \$8.1 million profit.

found the ADR transaction to be legitimate, and allowed IES to take the foreign tax credit.

The district court held that the transaction was a sham because “the only change in IES’s ‘economic position’ as a result of the ADR transactions was ‘the transfer of the claim to the foreign tax credit to IES.’”¹⁰⁸ The Eighth Circuit reversed, arguing that since IES had a profit from the dividends, absent all tax considerations,¹⁰⁹ the pre-tax profit test had been met.¹¹⁰ To make this conclusion, the court found that 100% of the dividend was income, and not just the 85% received in cash.¹¹¹ Again, citing the *Old Colony Trust* holding, the court found that “the foreign corporation’s withholding and payment of the tax on IES’s behalf is no different from an employer withholding and paying to the government income taxes for an employee.”¹¹²

In summary, both the Fifth and Eighth Circuits found that the pre-tax profit test should not consider the costs each company incurred in foreign tax on the income. Each court found that the party involved had realized a profit prior to paying the foreign tax and that such a profit was sufficient to meet the pre-tax profit test. It did not matter that the company never actually received the profit because it was ultimately withheld by the foreign entity to pay off the resulting tax liability. The amount withheld for the foreign tax liability was still income under the principles held in *Old Colony Trust*. Yet, despite these holdings, more recent decisions from other circuits have rejected this idea.

B. The First, Second, and Federal Circuits Disagree, Citing the Policy Underlying the Foreign Tax Credit.

The First Circuit, Second Circuit, and Federal Circuit did not agree with the Fifth and Eighth Circuits. While analyzing a different type of transaction, often coined the “STARS” transaction,¹¹³ these circuits have held that foreign taxes should be treated as costs when calculating pre-tax profit.

i. The “STARS” Transaction Dissected

Unlike in the dividend stripping transactions, the STARS (Structured Trust Advantaged Repackaged Securities) transaction involves multiple “arms,” circular cash

108. *Id.* at 354.

109. *Id.* IES had a net profit before any of the tax considerations because the dividend income exceeded the capital loss.

110. *Id.*

111. *Id.*

112. *IES Indus. Inc.*, 253 F.3d at 354.

113. *Bank of N.Y. Mellon Corp. v. Comm’r*, 801 F.3d 104, 107 (2nd Cir. 2015). STARS stands for “Structured Trust Advantaged Repackaged Securities,” a type of asset-backed trust created by Barclays Bank, KPMG, and Sidley Austin to take advantage of the differences in international tax codes to generate foreign tax credits.

flows, and several entities.¹¹⁴ Profit is generated from income generating assets purchased with funds on ‘loan’ from a bank.¹¹⁵ The loan is obtained at below-market interest rates because it is set up to maximize tax benefits to the foreign lender using a preferable tax classification in the lender.¹¹⁶ The tax benefits are then shared between both the foreign lender and the US entity in the form of a payment by the foreign lender to the US entity for half of its tax bill in the foreign country.¹¹⁷ The US entity then takes the foreign tax credit for the full amount paid and essentially recognizes a ‘profit’ in the form of the kickback from the foreign lender.¹¹⁸

To illustrate further, using the Second Circuit’s case *Bank of N.Y. Mellon Corp. v. Comm’r* as a model, we will first start with the intricate set-up of the relevant entities. UK bank Barclays, headquartered in London, and hereinafter referred to as UK-B, entered an agreement with a US Bank, Bank of New York Mellon Corp, hereinafter referred to as US-B, to engage in a STARS transaction.¹¹⁹ The transaction began with US-B creating a Delaware trust, and contributing \$7.8 billion in income-producing assets.¹²⁰ These assets would be used to generate all the income for the trust. A UK resident was appointed as the trustee to intentionally subject the trust’s income to UK taxes.¹²¹ In return, US-B received nominal class A and B shares in the trust for its contribution.¹²² Figures 6 and 7 below show the relevant entities and their relationships.

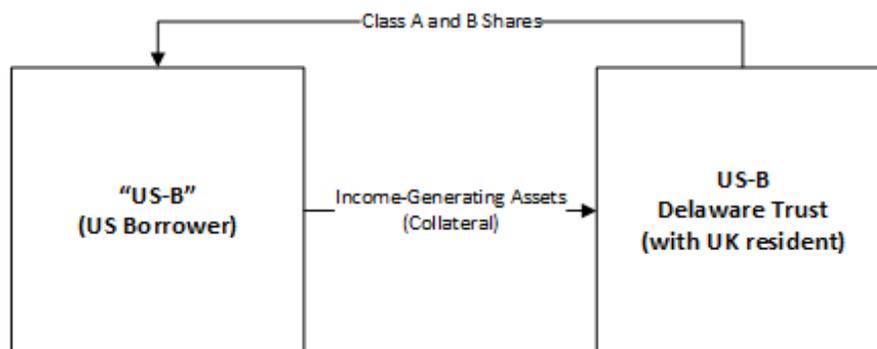


Figure 6 – The Creation of the STARS Trust by US-B

US-B then purchased Class C and D shares in the trust for \$1.5 billion so that the trust would contain both the income generating assets and the \$1.5 billion.¹²³

114. See generally *IES Indus. Inc.*, 253 F.3d at 354; *Bank of N.Y. Mellon Corp.*, 801 F.3d 104.

115. See generally *IES Indus. Inc.*, 253 F.3d at 354; *Bank of N.Y. Mellon Corp.*, 801 F.3d 104.

116. See generally *IES Indus. Inc.*, 253 F.3d at 354; *Bank of N.Y. Mellon Corp.*, 801 F.3d 104.

117. See generally *IES Indus. Inc.*, 253 F.3d at 354; *Bank of N.Y. Mellon Corp.*, 801 F.3d 104.

118. See generally *IES Indus. Inc.*, 253 F.3d at 354; *Bank of N.Y. Mellon Corp.*, 801 F.3d 104.

119. *Bank of N.Y. Mellon Corp.*, 801 F.3d at 110.

120. *Id.*

121. *Id.*

122. *Id.*

123. *Id.*

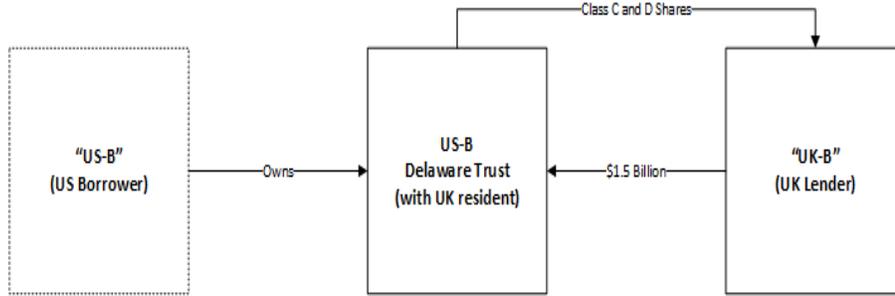


Figure 7 – UK-B’s Contribution to the STARS Trust

US-B and UK-B agreed that UK-B would pay US-B a monthly amount equal to half of the UK taxes the trust would have to pay on its income (see Figure 9 below).¹²⁴ This last agreement was a kick back to US-B so that each entity would equally share in the tax liability assessed by the UK government on any income generated from the trust.¹²⁵ The \$1.5 billion was essentially treated as a loan because, at the end of five years, US-B agreed to repay UK-B for the Class C and D shares for the exact same amount that UK-B had paid to acquire them¹²⁶ and each month the trust would make monthly interest payments to UK-B.¹²⁷

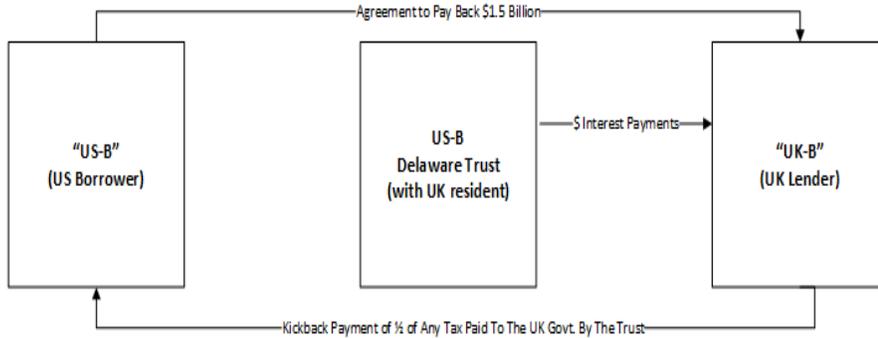


Figure 8 – Direct Agreements between US-B and UK-B in STARS

124. *Id.*
 125. See *Bank of N.Y. Mellon Corp.*, 801 F.3d at 110.
 126. *Id.*
 127. *Id.* at 111.

Finally, at the end of the five years, US-B and UK-B would go their separate ways and the trust would dissolve.¹²⁸ The final dissolution of the trust is illustrated in Figure 9.

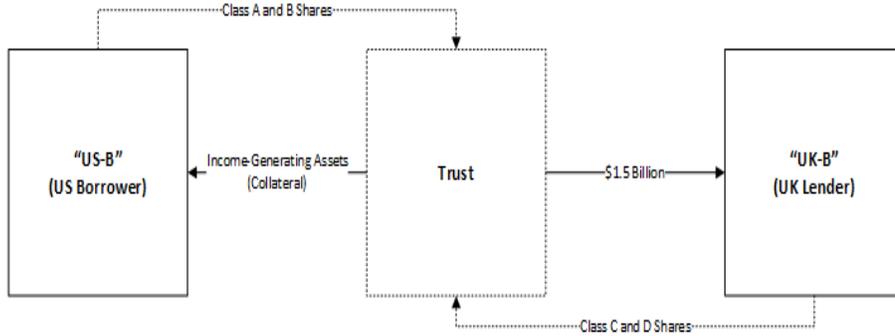


Figure 9 - The Eventual Dissolution of the STARS Trust

Each month the trustee would either pay taxes to the UK government or withhold taxes for later payment and then the trust would make a monthly class C distribution to UK-B with the remaining income.¹²⁹ The distribution would be made to a special Barclays account that was “blocked”, meaning that UK-B could not access any of its funds.¹³⁰ Since UK-B could not access the funds or control the account, it would immediately return the distribution to the trust, which would then pass the distribution back to US-B.¹³¹ The circular flow of income that resulted from the arrangement is shown in Figures 11-13 below. The tax effects of this circular cash flow are best illustrated, as the court did in its opinion, using a hypothetical \$100 of trust income.¹³²

128. *Id.*

129. *Id.*

130. *Id.*

131. *Bank of N.Y. Mellon Corp.*, 801 F.3d at 111.

132. *Id.*

First, on \$100 of trust income, US-B would pay \$22 to the UK for taxes.¹³³ This is because the capital gains rate at the time was 22% in the UK.¹³⁴ The remaining \$78 would be available for distribution to the shareholders.¹³⁵ At the same time, UK-B would be taxed by the UK government on all the trust income at the 30% ordinary income tax rate because under UK tax law, UK-B, as owner of the Class C stock, was considered the owner of almost all of the trust income.¹³⁶ Thus, for every \$100, UK-B would be liable for \$30 in tax. But, since US-B already paid 22% to the U.K. on that same income, UK-B could claim a credit for the \$22 paid by US-B, and only \$8 of tax liability remained.¹³⁷ The \$78 of income left in the trust would then be transferred to UK-B's blocked account as a Class C distribution.¹³⁸

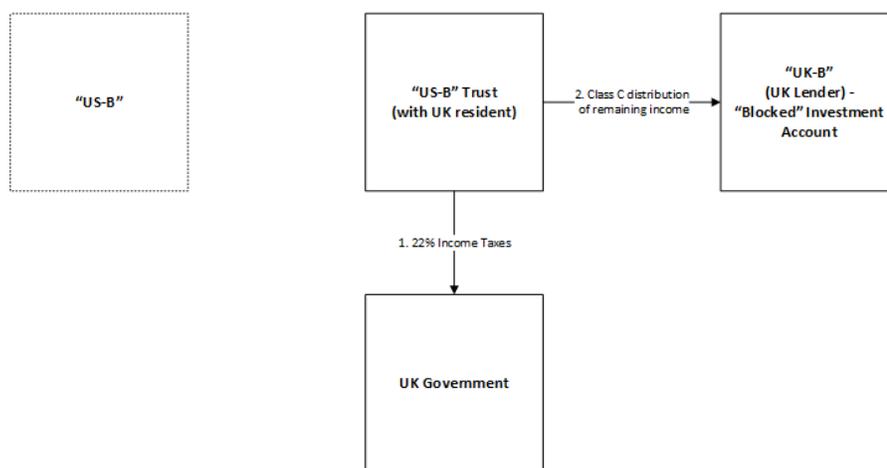


Figure 10 - US-B trust pays UK tax and distributes remaining income to UK-B.

However, since UK-B could not access the funds, it would transfer it back to the trust.¹³⁹ This transfer back out of the "blocked" account would trigger a taxable event whereby, under UK tax law, UK-B would get to treat the cash flow out of the blocked account as a trading loss.¹⁴⁰ The trading loss would essentially be a \$78 deduction that UK-B would get to use to offset some of its taxable income. At the ordinary income tax rate of 30%, the net benefit to UK-B was a reduction in its tax liability that was worth about \$23.40.¹⁴¹ When this benefit of \$23.40 is netted

133. *Id.*

134. *Id.*

135. *Id.*

136. *Bank of N.Y. Mellon Corp.*, 801 F.3d at 111.

137. *Id.*

138. *Id.*

139. *Id.*

140. *Id.*

141. The \$23.40 is calculated by taking the ordinary income tax rate of 30% and multiplying it by the \$78 of taxable income that UK-B would no longer have to pay taxes on. *Id.* The result is a tax liability that is \$23.40 less than it would have been if the \$78 of income had been included in taxable income. (\$78 * 30% = approximately \$23.40). *See id.*

against the additional \$8 tax liability UK-B owed to the UK, UK-B ended up not having to pay the \$8 tax liability and had approximately \$15.40 left that it could use to offset its taxes arising from other transactions.¹⁴²

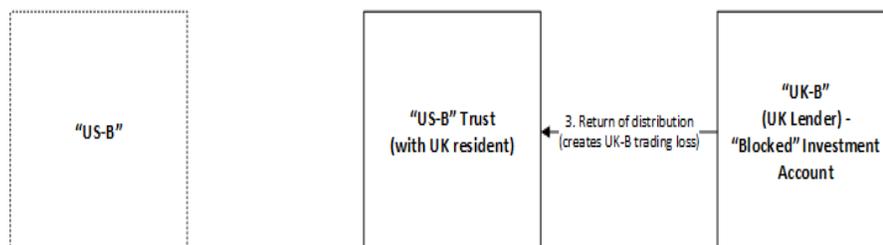


Figure 11 - The remaining 78% income is transferred back from the Barclays Blocked Account.

However, per the agreement between UK-B and US-B, UK-B still owed US-B half of the taxes that US-B paid to the UK government on behalf of the trust.¹⁴³ Thus, UK-B would finally pay US-B \$11, half of the \$22 originally paid to the UK.¹⁴⁴ Furthermore, since the \$11 paid to US-B also counted as a deduction, UK-B realized \$3.30 of tax benefit.¹⁴⁵ In total, UK-B had a net tax benefit of \$7.70.¹⁴⁶ This is because it had a benefit of \$15.40, paid out \$11, but gained back the \$3.30.¹⁴⁷

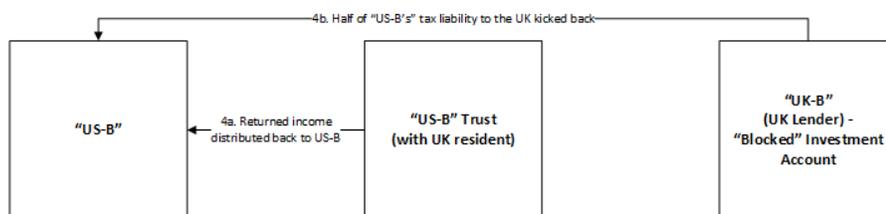


Figure 12 - Half the UK tax liability is kicked back to US-B & the remaining income is paid to US-B.

Meanwhile, because of the foreign tax credit, US-B took the full \$22 as a tax credit in the US, meaning that it did not have to pay any additional tax to the US government on the trust income. Then, US-B would receive the \$11 payment from UK-B. So, US-B made \$11 on every \$100 of trust income. In total, the United States did not collect any tax revenue from the transaction, and the UK only collected an

142. *Bank of N.Y. Mellon Corp.*, 801 F.3d at 111.

143. *Id.*

144. *Id.* The \$11 is half of the original \$22 paid by US-B to the U.K. government on the \$100 of trust income (the capital gains rate was assumed to be 22%).

145. *Id.* The \$11 paid to US-B also counted as a deduction. At the 30% rate, that \$11 off taxable income was approximately \$3.30 off tax liability. This is calculated by multiplying \$11 * 30%.

146. *Id.*

147. *Id.*

effective \$3.30 per every \$100.¹⁴⁸ In the tax years of 2001 and 2002, US-B claimed \$7.6 million in interest expense deductions and foreign tax credits of \$198.9 million.¹⁴⁹

ii. The Second Circuit: *Bank of N.Y. Mellon Corp. v. Commissioner*

In *Bank of N.Y. Mellon Corp. v. Comm'r*, the Second Circuit analyzed the STARS transaction described above and found it to be a sham.¹⁵⁰ To attack the transaction, the court first broke up the trust and the loan and analyzed them separately.¹⁵¹ The court explained its approach by saying that the purpose behind the separation of the transaction and the loan was to prevent corporations from simply skirting the pre-tax profit test by combining any regular transaction with one designed to generate tax benefits.¹⁵² The court argued that “the purpose of calculating pre-tax profit . . . is not to perform mere financial accounting, subtracting costs from revenue on a spreadsheet: It is to discern, as a matter of law, whether a transaction meaningfully alters a taxpayer’s economic position other than with respect to tax consequences.”¹⁵³

Thus, the court held, foreign taxes paid must be included in calculating pre-tax profit to determine if, absent the *tax benefit*, a prudent investor would have entered the transaction.¹⁵⁴ The court relied heavily on the purpose of the economic substance doctrine to justify the inclusion of the foreign tax.¹⁵⁵ The argument was that since a prudent investor would simply consider the foreign tax as a cost of the transaction, it should be included in the pre-tax profit test.¹⁵⁶

Further, it argued that the transactions “fictionalized” the concept of international trade.¹⁵⁷ The court found that the funds contributed to the US trust never actually left the United States, and were cycled through a “blocked account” only for generating a tax benefit to UK-B that could then be shared by both companies.¹⁵⁸ Absent these tax benefits to UK-B, US-B would have never had a profit.

iii. The First and Federal Circuits Agree

In *Salem Financial, Inc. v. United States*, the Federal Circuit also analyzed a

148. *Bank of N.Y. Mellon Corp.*, 801 F.3d at 111. The U.K. initially received \$22 in capital gains tax on the trust, but lost \$18.70 (\$15.40 from the \$78 trading loss + \$3.30 from the \$11 payment to US-B) in potential tax on UK-B’s other income, resulting in only \$3.30 of net tax on every \$100. *Id.*

149. *Id.*

150. *Bank of N.Y. Mellon Corp.*, 801 F.3d at 125.

151. *Id.* at 113.

152. *Bank of N.Y. Mellon Corp. v. Comm’r*, 140 T.C. 15, 34 (2013) (citing *Long Term Capital Holdings v. United States*, 330 F. Supp. 2d 122, 183 (D. Conn. 2004)).

153. *Bank of N.Y. Mellon Corp.*, 801 F.3d at 118.

154. *Id.* at 124 (emphasis added).

155. *Id.*

156. *Id.* at 119.

157. *Id.* at 118 (emphasis in original).

158. *Id.* at 111.

STARS transaction.¹⁵⁹ The transaction was between Barclays Bank and Salem Financial, Inc., a financial holding company and subsidiary of Branch Banking & Trust Corporation (BB&T).¹⁶⁰ In many respects, the transaction was nearly identical to the transaction in *Bank of N.Y. Mellon Corp.* BB&T would contribute income generating assets into a trust, and Barclays would place \$1.5 billion in cash in return for an equity interest and agreement to sell its interest back later, effectively creating a loan.¹⁶¹ BB&T would then pay tax on the income generated and distribute the post-tax income to a “Barclays Blocked Account,” which would then be returned to the trust.¹⁶² This circular flow of cash triggered many tax effects for Barclays that effectively reduced its UK tax bill.¹⁶³

Barclays would then share those benefits with BB&T by making a monthly payment that was very similar to the kickback payment in *Bank of N.Y. Mellon Corp.*¹⁶⁴ The payment to BB&T, known as the “Bx payment,” was equal to 51% of the UK taxes paid by BB&T (through the trust).¹⁶⁵ Finally, a “make-whole” provision was included in the trust agreement to ensure that if the trust failed to generate tax benefits to Barclays, BB&T would reimburse Barclays, or if the trust paid no tax, BB&T would make an indemnity payment to Barclays that would be about one-half of the UK tax that the trust would have had to pay.¹⁶⁶

Like the Second Circuit, the Federal Circuit was not fond of the transaction. Initially, both the IRS and BB&T had argued that the Bx payments were income, and thus “profit.”¹⁶⁷ Despite initially agreeing with BB&T, the IRS retracted and then argued that the payment was simply a tax rebate.¹⁶⁸

The court sided with BB&T, finding that “the Bx payments could just as well be said to have been derived from the portion of Barclays’ tax benefits that was independent of BB&T’s UK tax payments.”¹⁶⁹

Thus, having lost on the argument that BB&T had no income, the IRS then turned to the “pre-tax profit” test to argue that the transaction was a sham because, even if BB&T had \$11 of income, it netted \$-11 after the \$22 tax.¹⁷⁰ The court agreed with the government and held that the rationales in *Compaq* and *IES* were flawed because nearly all tax shelters are designed to produce a profit after all taxes are accounted for.¹⁷¹ Thus, rather than consider a transaction with all its tax effects, the court claimed that it should consider the transaction absent all tax effects,¹⁷² and so argued that the foreign tax was not actually a tax effect.

Recently, in December of 2016, the First Circuit weighed in on the treatment

159. 786 F.3d 932, 937 (Fed. Cir. 2015).

160. *Id.* at 936.

161. *Id.* at 937.

162. *Id.*

163. *Id.*

164. *Id.* at 937–38.

165. *Salem Fin., Inc.*, 786 F.3d at 938.

166. *Id.* at 939.

167. *Id.* at 943.

168. *Id.*

169. *Id.* at 946.

170. *Id.* at 946–47.

171. *Salem Fin., Inc.*, 786 F.3d at 948.

172. *Id.*

of STARS as well.¹⁷³ Again, the structure of the transaction was like that in *Bank of N.Y. Mellon Corp* and *Salem Financial*.¹⁷⁴ The court found the arrangement to be a sham, stating “The STARS scheme is profitable only because Sovereign plans to obtain US tax credits; that is, the whole existence of the Trust transaction depends on getting a US tax credit.”¹⁷⁵ Quoting the policy concerns of the Second Circuit, the First Circuit argued that the STARS Trust did not have a chance of generating a profit without a foreign tax credit.¹⁷⁶ Furthermore, the court argued that the principle of avoiding double taxation could not save the transaction either, because to allow the credit would be to allow “every tax avoidance scheme.”¹⁷⁷

V. RECONCILING THE COMPETING POLICY ARGUMENTS

With three circuits holding that the objective pre-tax profit test should consider foreign taxes before finding a profit, and two circuits holding that it should not, a circuit split has emerged. Even though the formation and operation of the ADR transactions are markedly different from that of the STARS transactions, both have a similar outcome. The US taxpayer incurs a foreign tax expense that exceeds profit made from the rest of the transaction. If the expense is factored into the pre-tax profit test as a cost of doing business and not a “tax consequence,” the transaction fails the pre-tax profit test, because it results in an overall economic loss. If the expense is not factored into the pre-tax profit test because it is considered a “tax effect” of the transaction, it passes because there was a “pre-tax profit.” The relevant question is: “Does pre-tax profit mean pre-US tax profit or pre-any-tax profit?”

A. The Fifth and Eighth Circuits: “Pre-tax Profit” Really Means “pre-tax profit” in all Contexts.

As mentioned above,¹⁷⁸ the Fifth and Eighth Circuits take the broader point of view and rely on the policy stated in *Old Colony Trust Co v. Comm’r*¹⁷⁹ that income is income to the taxpayer even if it has been earmarked to be paid to a government as a tax.¹⁸⁰ Part of this holding relied on the fact that in the ADR transactions, the foreign tax paid was usually held back by the foreign country.¹⁸¹ But the court argued that the underlying policy remains.¹⁸² Income made prior to taxation is still income, and thus a taxpayer’s economic position has changed.

This approach tends to focus on the pre-tax profit test’s objectivity and defers

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

174. *Id.* at 19–21.

175. *Id.* at 18.

176. *Id.* at 23.

177. *Id.* at 26.

178. See *supra* Section IV.A.

179. 279 U.S. 716 (1929).

180. *Id.* at 729. (As mentioned before, this concept is derived from the concept that “The discharge by a third person of an obligation to him is equivalent to receipt by the person taxed.”)

181. *Id.*

182. *Id.*

to the *business purpose* prong of the test for any additional analysis of the taxpayer's motivations for entering the transaction.¹⁸³ Applying the Fifth and Eighth Circuits's application of the pre-tax profit test to the STARS transactions analyzed by the First, Second, and Federal Circuits would result in a finding that the transaction was legitimate because BB&T (or BNY) made a profit of \$11 out of every \$100 from the Bx payments.¹⁸⁴ Absent any tax consequence, it passes. After all, even if the transaction does not have a pre-tax profit, the subjective prong could still find that the transaction was a "shelter" and deem it ineligible for the foreign tax credit.

Thus, the Fifth and Eighth Circuits would prefer to view each prong as its own island and perform a balancing test between the two after both have been separately analyzed. The deference given to each of the prongs more closely reflects the intention of having the subjective prong. The subjective prong recognizes that the objective "pre-tax profit" test cannot capture the economic reality of all transactions analyzed under the economic substance doctrine.

B. The First, Second, and Federal Circuits: "Pre-tax Profit" Really Means "Pre-US Tax Profit"

The First, Second, and Federal Circuits would rather consider the transaction from the narrower point of view that "absent tax consequences" really means "pre-US tax profit." This view is justified by the policy of the foreign tax credit itself. The purpose of the foreign tax credit is to prevent "double taxation" and "to facilitate global commerce by making the IRS indifferent as to whether a business transaction occurs in this country or in another."¹⁸⁵ Put differently, the foreign tax credit is designed to help companies compete with international business without being disadvantaged by being taxed by multiple governments on the same income.¹⁸⁶ Thus, in transactions of the type discussed here, if the income will at least be taxed once, and a single tax assessment by *any* country would make the transaction unprofitable, the transaction does not fall within Congress's intent for creating the foreign tax credit because no economic benefit or "trade" is being created by granting the credit. The transaction could only then be saved by the "business-purpose" prong, with the burden being on the taxpayer to show that the transaction had another purpose other than to obtain a tax benefit.

This approach recognizes the reality that, because tax shelters involving foreign tax credits are typically motivated by the taxpayer's willingness to subject itself to foreign taxes for some benefit (other than differences in the applicable tax rate),¹⁸⁷ a test that considers none of the tax effects and all the tax effects should

183. *See id.*

184. The profit in this case is just the kickback payment from the UK bank. Since the US entity would have to pay a tax somewhere, whether to the US or the UK, the \$22 tax is ignored under the rationale of Fifth and Eighth Circuits because, in that context, the pre-tax profit test considers profit absent all tax.

185. *Bank of N.Y. Mellon Corp.*, 801 F.3d at 107, 118.

186. Herman B. Bouna, *What is the Purpose of the Foreign Tax Credit? – A True and False Quiz: Can You Ace It?*, BLOOMBERG BNA, (Jan. 7, 2011), <http://www.bna.com/purpose-foreign-tax-n8589934989/>.

187. This is because the taxpayer will ultimately have to pay the amount of the US tax in some way. If the UK taxes \$100 of income at 22%, and the US taxes that income at 35%, the US liability would be \$35 - \$22 foreign tax credit, leaving a remaining \$13 bill. One possible reason why a taxpayer would subject itself to the foreign taxes might be to take advantage of the differing treatment of the income under each

yield the same result, i.e., a profit. As the court in *Salem Financial* stated, “all tax shelter transactions produce a gain for the taxpayer after the tax effects are taken into account – that is why taxpayers are willing to enter into them and to pay substantial fees to the promoters.”¹⁸⁸ Thus, a test that does not allow the court to consider foreign taxes as expenses will always validate a transaction if *some* income was produced, regardless of the size of the resulting tax bill.

C. The IRS' Response

In 1998, shortly after the ADR transactions were initially challenged, the IRS proposed a regulation to “disallow foreign tax credits in an arrangement . . . from which the reasonably expected economic profit is insubstantial compared to the value of the foreign tax credits expected to be obtained as a result of the arrangement.”¹⁸⁹ In other words, the IRS chose to challenge transactions that generated a large foreign tax credit but had a substantially low potential profit. In doing so, the IRS expressly said that it would consider foreign taxes paid as an expense of the transaction.¹⁹⁰ However, the regulations were never enacted. In 2004, the IRS withdrew the 1998 notice.¹⁹¹ It did not provide any reason for the withdrawal, stating only that “the IRS remain concerned about transactions that involve inappropriate foreign tax credit results,” and that “[t]he tax benefits claimed in these transactions are inconsistent with the purposes of the foreign tax credit provisions . . . which are intended to reduce or eliminate double taxation of income.”¹⁹²

Despite the withdrawal, the codification of the economic substance doctrine in 2010 brought back the IRS' intended solution.¹⁹³ Under I.R.C. section 7701(o)(2)(A), the pre-tax profit test will be met only if “the present value of the reasonably expected pre-tax profit from the transaction is substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected.”¹⁹⁴ In other words, the court will find that a transaction passes the pre-tax profit test if the profit from the transaction is not insubstantial in relation to its net tax benefits.¹⁹⁵

Additionally, Congress clarified its position on the treatment of foreign taxes with respect to calculating the profit.¹⁹⁶ I.R.C. section 7701(o)(2)(B), titled “Treatment of fees and foreign taxes,” clarifies that “Fees and other transaction expenses shall be taken into account as expenses in determining pre-tax profit,” and that

tax code, such as the case with the distributions to the Barclays Blocked Account in the STARS context. But, differences in the rate alone would not be sufficient.

188. *Salem Fin., Inc. v. United States*, 786 F.3d 932, 948 (2015).

189. I.R.S. Notice 98-5, 1998-1 C.B. 334.

190. *Id.* In Notice 98-5, the IRS stated, “In general, reasonably expected economic profit will be determined by taking into account foreign tax consequences (but not U.S. tax consequences).” *Id.*

191. I.R.S. Notice 2004-19, 2004-1 C.B. 606.

192. *Id.*

193. See 26 U.S.C. § 7701(o) (2012).

194. *Id.* § 7701(o)(2)(A).

195. *Id.*

196. *Id.* § 7701(o)(2)(B).

“[t]he Secretary shall issue regulations requiring foreign taxes to be treated as expenses in determining pre-tax profit in appropriate cases.”¹⁹⁷ While “appropriate cases” remains to be defined, it is clear that Congress has intended to limit the pre-tax profit test to profit earned after foreign taxes, but before US tax.

VI. FOREIGN TAXES SHOULD BE TREATED AS AN EXPENSE WHEN DETERMINING PRE—TAX PROFIT

Going forth, the approach of the First, Federal, and Second Circuits is correct, because it is consistent with the language of the codified economic substance doctrine and with the underlying policies of the foreign tax credit.

First, the plain language of the codified economic substance doctrine supports the findings of the First, Second, and Federal Circuits. I.R.C. section 7701(o)(A) clarifies that the transaction must “change[] in a meaningful way (*apart from Federal income tax effects*) the taxpayer’s economic position.”¹⁹⁸ By applying the usual and ordinary meaning of the words in the statute, the inclusion of the word “Federal” evidences Congress’s intent to only exclude domestic tax effects, and not foreign tax effects. Additionally, I.R.C. section 7701(o)(2), titled “Special rule where taxpayer relies on profit potential,” further explains that the treatment of “Fees and other transaction expenses shall be taken into account as expenses in determining pre-tax profit.”¹⁹⁹ Specifically, section 7701(o)(2)(B) requires the issuance of “regulations requiring foreign taxes to be treated as expenses in determining pre-tax profit.”²⁰⁰ Thus, the plain meaning of the statute shows that Congress did not intend for the pre-tax profit test to exclude foreign taxes paid in determining if the taxpayer’s economic position has changed.

Additionally, the approach of the First, Federal, and Second Circuits is supported by the policy of the foreign tax credit itself. The approach recognizes the reality that by not factoring foreign taxes into the pre-tax profit test, a taxpayer could simply add an income stream to an arrangement, such as the “Bx payment” in the STARS context, and render the pre-tax profit test meaningless. To do so would be to defeat Congress’s intention of allowing the foreign tax credit because no new business or economic substance is created. For example, in the STARS context, the circular cash flows amongst the various entities indicated that no profit was expected other than the “kickback” payment. Absent the tax benefits realized to Barclays Bank and the subsequent sharing of those benefits in the “kickback” payment, the transaction would not have been profitable for BNY. Thus, no further competition or global commerce was facilitated by giving the tax credit.

Some proponents of STARS have defended it on the basis that none of the resulting tax consequences affect the US entity, other than to allow a foreign lender to offer cheaper borrowing.²⁰¹ Former IRS associate chief counsel, Kevin Dolan, argues that the reason why the court erred in holding against STARS transactions is because the act of helping a foreign entity take advantage of their tax code is not

197. *Id.*

198. *Id.* § 7701(o)(1)(A) (emphasis added).

199. *Id.* § 7701(o)(2)(B).

200. *Id.*

201. Dolan, *supra* note 6, at 835.

the same as making a transaction that avoids US tax.²⁰² He argued, “the fact that U.S tax law characterizes the transaction differently from foreign tax law is irrelevant and merely reflects the foreign lender’s foreign tax motivation.”²⁰³ No element of the STARS transaction violated the requirements of the Internal Revenue Code.²⁰⁴ Despite all the entities and cash flows that were used to secure Barclays’ preferred UK tax treatment, BNY ignores it all when reporting to the IRS.²⁰⁵ It simply says, “we paid this foreign tax, and got a kickback (of about half) from Barclay’s.”²⁰⁶ With respect to US-B, under the Internal Revenue Code, none of the circular cash flows affect them.²⁰⁷

While these arguments are persuasive, they more accurately argue why the court got the holding wrong with respect to the “business-purpose” test, and not the “pre-tax profit” test. If the court were to hold that the pre-tax profit test should not factor in foreign taxes, a corporation could simply contract to receive an insignificant payment or income stream from the transaction to skirt potential issues with the objective prong’s profit requirement. The IRS foresaw this potential abuse and attempted to address it in its 1998 notice when it proposed regulations denying the credit in cases where “reasonably expected economic profit is insubstantial compared to the value of the foreign tax credits expected to be obtained.”²⁰⁸ In passing I.R.C. section 7701(o)(2)(A), Congress has evidenced its concern over this as well.²⁰⁹ Instead, by requiring a profit after foreign taxes are assessed, the court ensures that only transactions that meaningfully change the taxpayer’s net economic position could pass.

Finally, the approach of the First, Second, and Federal Circuits recognizes the reality that no prudent investor would enter a transaction that yields a loss absent tax *benefits*.

While the Fifth and Eighth Circuits rely on *Old Colony* to hold that *any* pre-tax profit is sufficient to establish a change in the taxpayer’s economic position, the holdings of the First, Second and Federal Circuits more accurately argue that the question is really about the taxpayer’s *net* position. In *Compaq Computer Corp*, the Fifth Circuit argued that treating foreign tax as an expense would “stack the deck against finding the transaction profitable” and “[t]o be consistent, the analysis should either count all tax law effects or not count any of them.”²¹⁰ But the opposite is also true if foreign taxes are excluded from the pre-tax profit test. Where including the foreign tax causes the transaction to fail the test, and excluding the tax causes it to pass, a rule that foreign taxes should be excluded from the test would

202. *Id.* at 833.

203. *Id.* (emphasis omitted).

204. *Id.*

205. *Bank of N.Y. Mellon Corp. v. Comm’r*, 801 F.3d 104, 111 (2nd Cir. 2015).

206. *Id.*

207. *See id.*

208. I.R.S. Notice 98-5, 1998-1 C.B. 334.

209. 26 U.S.C. § 7701(o)(2)(A) (West 2017) (providing that the requirements of 26 U.S.C. § 7701(o)(1)(A) “are met with respect to the transaction only if the present value of the reasonably expected pre-tax profit from the transaction is substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected”).

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

stack the deck *in favor* of finding the transaction profitable, which is equally concerning.

Since a taxpayer must pay tax on its foreign income to at least one country, the amount of the tax is implicit in the transaction. A prudent investor is assumed to consider those tax effects when estimating the profitability of a venture. Therefore, a test that considers foreign taxes as an expense of the transaction more accurately reflects the *net* change in the taxpayer's economic position. Consequently, if the court strips the tax benefits from the equation and concludes that a prudent investor would not invest in the transaction without them, then the transaction is likely a sham and is not the type that Congress intended to encourage by granting the foreign tax credit.

VII. CONCLUSION

In summary, the First, Federal, and Second Circuits are correct. In determining pre-tax profit, taxes paid to a foreign government should be considered an expense of the transaction and not a tax. This approach is more consistent with the plain language of the 2010 codification of the economic substance doctrine and with the underlying policy of the foreign tax credit. By creating the foreign tax credit, Congress did not intend to allow taxpayers to engage in transactions that generate large tax benefits but do not meaningfully alter their economic position. If a transaction yields a loss after foreign taxes, then it did not meaningfully alter the taxpayer's economic position and should fail the pre-tax profit test.