No. 15 - ____

IN THE

Supreme Court of The United States

AMERICAN INTERNATIONAL GROUP, INC.,
Petitioner,

v.

UNITED STATES OF AMERICA,
Respondent.

On Petition for a Writ of Certiorari
To the United States Court of Appeals
For the Second Circuit

PETITION FOR A WRIT OF CERTIORARI

David Boies
COUNSEL OF RECORD
Robin Henry
Edward Normand
BOIES, SCHILLER & FLEXNER LLP
333 Main Street
Armonk, New York 10504
(914) 749-8200
dboies@bsfllp.com

Thomas A. Cullinan
SUTHERLAND ASBILL & BRENNAN LLP
999 Peachtree Street, N.E.
Atlanta, Georgia 30309
(404) 853-8000

Jerome B. Libin
Daniel H. Schlueter
SUTHERLAND ASBILL & BRENNAN LLP
700 Sixth Street, NW #700
Washington, DC 20001
(202) 383-0100

QUESTION PRESENTED

U.S. taxpayers are taxed in the United States on both income earned in the United States and income earned in foreign countries. Foreign countries also routinely tax U.S taxpayers on the income they earn in those countries. The Internal Revenue Code allows U.S. taxpayers to claim a dollar-for-dollar credit for qualifying foreign taxes paid. Congress intended to treat any such foreign income tax as the equivalent of U.S. income tax. The purpose of the foreign tax credit is to avoid double taxation of foreign transactions and remove tax impediments to business outside of the United States.

Several lower courts have imposed a further requirement for securing the foreign tax credit – that the activity upon which foreign tax is paid must have "economic substance," a requirement that typically focuses on whether the activity was expected to generate a "pre-tax profit." In the decision below, the Second Circuit held that for purposes of the economic substance requirement, U.S. taxpayers who earn income abroad must re-compute pre-tax profit to treat foreign tax as an expense. That holding is contrary to Congress' intent and is in express disagreement with the Fifth and Eighth Circuits. The decision plainly discriminates against, and calls into question a wide range of routinely conducted, cross-border transactions. Indeed, the Second Circuit acknowledged that its decision makes it more likely that foreign investment will fail the judicially imposed economic substance requirement.

The question presented is whether the Second Circuit erred in impeding, and discriminating against, foreign investment by treating foreign income taxes not as taxes, but as expenses, in determining entitlement to the foreign tax credit.

CORPORATE DISCLOSURE STATEMENT

Petitioner, American International Group, Inc. ("AIG"), is incorporated under the laws of Delaware. AIG has no parent corporation, and no publicly held corporation owns ten percent or more of AIG's stock.

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PETITION FOR A WRIT OF CERTIORARI

Petitioner, AIG, respectfully petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Second Circuit in this case.

OPINIONS BELOW

The opinion of the Court of Appeals for the Second Circuit (Pet. App. 3a-46a) is available at 2015 WL 5234396. The opinion of the district court (Pet. App. 47a-66a) is available at 2013 WL 1286193.

STATEMENT OF JURISDICTION

The decision of the Court of Appeals for the Second Circuit was issued, and judgment was entered, on September 9, 2015. This Court has jurisdiction under 28 U.S.C. § 1254(1).

STATUTORY AND REGULATORY PROVISIONS INVOLVED

Selected portions of Sections 78, 901, and 951 of the Internal Revenue Code, 26 U.S.C. §§ 78, 901, and 951, and of 26 C.F.R. § 1.901-2(a)(2), are attached at Pet. App. E-H.

STATEMENT OF THE CASE

This case presents an issue of critical importance to U.S. taxpayers engaged in cross-border business transactions. The current split among the Circuits pits the Second and Federal Circuits against the Fifth and Eighth Circuits. This Court's guidance is essential to resolve the pending controversy.

A. The Transactions at Issue

AIG claimed foreign tax credits in connection with six cross-border financing transactions entered into between 1993 and 1997 by AIG Financial Products Corp. ("AIG-FP"), a wholly owned subsidiary of AIG. AIG-FP was engaged in a global financial-services business, part of which was spread banking, in which it sought to make a profit by borrowing funds at rates generally below LIBOR and investing those funds at rates generally above LIBOR.

In each of the six transactions, AIG-FP formed an affiliate (a portfolio company) in a foreign country to invest funds borrowed from an unrelated foreign bank.[1] AIG-FP sold preferred stock in the portfolio company to the foreign bank and contracted to repurchase that stock for the same price after a term of years. The portfolio company then invested the proceeds from the sale of the preferred stock, along with funds that AIG-FP contributed in exchange for the portfolio company's common stock, in a portfolio of income-producing securities.

Under U.S. tax law, this sale and repurchase of preferred stock is treated as a fixed-term loan from the foreign bank to AIG-FP, secured by the preferred stock. As a result, for U.S. tax purposes, the preferred dividends the portfolio company paid to the counterparty constituted deductible interest payments made by AIG-FP. Under the applicable foreign law, the counterparty bank was treated as the owner of the preferred stock. As a result, the preferred dividends received by the foreign bank were expected to be exempt from tax (through either an exemption or tax credit) or subject to a reduced tax rate. This anticipated favorable tax treatment for the foreign

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[1] Subsidiaries of AIG-FP formed the foreign affiliates that held the stock. The existence of these other subsidiaries is irrelevant to the issue presented in this Petition.

bank enabled it to lend funds to AIG-FP at a lower rate – through a lower dividend rate on the preferred stock – than the bank would have charged if the payments received had been subject to full income tax in its home country.

In each transaction, the portfolio company paid tax on its income to the foreign country where it was resident. Under the Internal Revenue Code, AIG also reported the income earned by the portfolio company on its U.S. corporate income tax return; deducted the amounts paid to the foreign bank as interest expense; calculated its resulting U.S. tax liability; and, as permitted by U.S. tax law, claimed credits against its U.S. tax liability for the foreign taxes paid by the portfolio company. These are the foreign tax credits at issue here.

B. Procedural History

There is no dispute that AIG complied with the complex rules and limitations imposed by the foreign tax credit statutory and regulatory regime in claiming the foreign tax credits at issue. *See* 26 U.S.C. §§ 901 *et seq.* The IRS nevertheless disallowed the claimed credits, finding that the cross-border transactions lacked "economic substance."

AIG paid the taxes that the IRS claimed were due and then initiated a refund suit in the district court. Moving for partial summary judgment,[2] AIG argued that the borrowing transactions had economic substance because they allowed AIG-FP to earn at least $168.8 million of pre-

[2] The motion was styled as such because there are unrelated issues in the case that have been severed and stayed to allow AIG and the Government to address them through the IRS administrative appeals process, and because the motion did not address a seventh cross-border transaction that was different in form from the six borrowing transactions at issue here.

tax profit using approximately $1.6 billion of borrowed funds. AIG calculated that profit by adding the amounts AIG-FP reasonably expected to earn from the borrowed funds and subtracting its borrowing costs, using figures provided by a government-retained expert.

The district court denied AIG's motion. In applying the economic substance doctrine, the court agreed that AIG would be entitled to judgment if its pre-tax profit computation of $168.8 million were correct. (A. 60a-61a.) It found, however, that AIG's computation improperly included the foreign tax benefits for the foreign banks. The district court held that the foreign tax benefits had allowed the interest rate to be set at a lower level and thus must be removed from pre-tax profit, netting AIG no profit from the transactions. (A. 64a-66a.)

The district court certified its order for interlocutory appeal under 28 U.S.C. § 1292(b), and AIG filed a petition for leave to appeal in the Second Circuit. The Second Circuit granted the petition and heard AIG's appeal together with an appeal filed in a different case by Bank of New York Mellon (the cases were not consolidated but were resolved in the same decision).

The Second Circuit affirmed the district court's order, but based on different reasoning than the district court had employed. Rather than requiring AIG to remove the effect of the foreign banks' tax benefits on the borrowing rates, the Second Circuit held that the foreign taxes paid by the portfolio companies "are economic costs and should thus be deducted when calculating pre-tax profit." (A. 45a.) Clearly announcing a general rule for all cross-border transactions, the Second Circuit stated: "We conclude, as a matter of first impression in this Circuit, that foreign taxes are economic costs and should thus be deducted when calculating pre-tax profit. We also conclude that it is appropriate, in calculating pre-tax profit, for a court both to include the foreign taxes paid and to exclude the foreign tax credits claimed." (*Id*.)

In so holding, the Second Circuit expressly disagreed with the holdings of the Fifth Circuit in *Compaq Computer Corp. v. Commissioner*, 277 F.3d 778 (5th Cir. 2001), and the Eighth Circuit *IES Industries, Inc. v. Commissioner*, 253 F.3d 350 (8th Cir. 2001). (A. 26a-33a.) In those cases, the Circuit Courts held that, in determining whether a transaction has economic substance, foreign taxes must be treated as taxes rather than as expenses for purposes of computing pre-tax profit and, therefore, that foreign taxes should not be counted in determining whether a transaction is profitable apart from its tax consequences.

REASONS FOR GRANTING THE WRIT

This Court should grant this Petition for three compelling reasons. First, as the Second Circuit acknowledged, its decision is in square conflict with the decisions of two other Circuits on the question presented. Second, the issue is fundamental to every U.S. taxpayer that relies on the foreign tax credit to alleviate double taxation. Third, this case presents the Court with the most suitable opportunity for resolving the Circuit split at issue.

I. THE SECOND CIRCUIT'S DECISION DIRECTLY CONFLICTS WITH THE FIFTH AND EIGHTH CIRCUITS ON THE IMPORTANT QUESTION OF HOW TO TREAT FOREIGN TAXES PAID WHEN MEASURING THE PRE-TAX PROFIT OF A CROSS-BORDER TRANSACTION FOR PURPOSES OF THE ECONOMIC SUBSTANCE DOCTRINE

The Circuits now are sharply divided on the question at issue, with the Second and Federal Circuits holding that foreign income taxes should be treated as expenses and the Fifth and Eighth Circuits holding that

they should be treated as taxes. Absent this Court's review, these conflicting decisions will result in the disparate tax treatment of identically situated taxpayers. The issue is recurring and of national importance because the discriminatory treatment of foreign income taxes as expenses – unlike U.S. income taxes, which are treated as taxes – impedes cross-border activity. Treating foreign income tax as an expense makes it more likely that a transaction in which foreign income tax is paid will fail the economic substance test – and therefore not be respected for U.S. tax purposes – relative to an otherwise identical transaction in which only U.S. income tax is paid. As the Second Circuit observed, "a transaction will be less likely to appear profitable under the objective prong of the economic substance test" if foreign income taxes are "treated as costs when calculating pre-tax profit." (A. 25a.) This treatment contravenes the well-established purposes of the U.S. foreign tax credit regime, which are to avoid double taxation for the U.S. taxpayer and to encourage foreign business activity.

A. The Economic Substance Test

The Supreme Court conceived the economic substance doctrine as a tool of statutory construction for furthering congressional intent. In *Gregory v. Helvering*, 293 U.S. 465 (1935), the Court explained that a court's task is to assess whether the tax results of a transaction are consistent with the purpose of the statute at issue – to assess "whether what was done . . . was the thing which the statute intended." *Id.* at 469. In subsequent cases assessing economic substance, the Court has considered whether the facts of a transaction fall within the meaning of the Code provision or regulatory guidance at issue. *See, e.g.*, *Cottage Savs. Ass'n v. Comm'r*, 499 U.S. 554, 562 (1991); *Frank Lyon Co. v. United States*, 435 U.S. 561, 583-84

(1978); *Knetsch v. United States*, 364 U.S. 361, 362-66 (1960).[3]

The lower courts have applied the economic substance doctrine by considering both objective and subjective factors. The factors are (1) whether the transaction has objective economic utility apart from its tax consequences and (2) whether the taxpayer has a subjective non-tax business purpose for entering into the transaction. The lower courts generally give greater weight to the objective part of the test, reasoning that "where a transaction objectively affects the taxpayer's net economic position, legal relations, or non-tax business interests, it will not be disregarded merely because it was motivated by tax considerations." *ACM P'ship v. Comm'r*, 157 F.3d 231,

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[3] The Second Circuit thus erred in applying the economic substance doctrine in the first place. Congress enacted the foreign tax credit to alleviate the effect of double taxation. *See Kraft Gen. Foods v. Iowa Dep't of Rev. & Fin.*, 505 U.S. 71, 73 (1992); *United States v. Goodyear Tire & Rubber Co.*, 493 U.S. 132, 139 (1989). Foreign tax credits can be claimed only when a genuine liability to a foreign tax authority actually has arisen and actually has been accrued or discharged by a payment of tax. *See* 26 U.S.C. § 901(a), (b)(1); 26 C.F.R. § 1.901-2(a)(2). The statute precisely defines the requirements for claiming the credit in a manner that fully implements the statutory purpose. In this case, there is no dispute that the credits at issue are attributable to foreign income taxes that actually were imposed by a foreign tax authority and actually paid by the AIG group, and that denial of the credits thus would result in the imposition of both U.S. and foreign tax on these foreign transactions. The Second Circuit's application of the doctrine to deny AIG these credits thus fails the basic test articulated by *Gregory*, 293 U.S. at 469. When, as here, application of the Code provisions accomplishes exactly "the thing which the statute intended," use of a judicial doctrine to depart from the statutory text is inappropriate. *See id.*

248 n.31 (3d Cir. 1998); *see also United States v. Consumer Life*, 430 U.S. 725, 739 (1997) ("Even a major motive to reduce taxes will not vitiate an otherwise substantial transaction."). Courts consider whether a transaction has economic substance by assessing whether it may have resulted in a "pre-tax profit." The lower courts generally compute pre-tax profit by adding the amounts the taxpayer reasonably expected to earn from a transaction and subtracting transaction costs. *See, e.g.*, *Goldstein v. Comm'r*, 364 F.2d 734, 740-43 (2d Cir. 1966).

B. The Circuits Are Split on How Foreign Taxes Should Be Treated in Determining Whether a Transaction Has Economic Substance

The Fifth Circuit in *Compaq Computer Corp. v. Commissioner*, 277 F.3d 778 (5th Cir. 2001), held that a fifteen percent Netherlands withholding tax imposed on dividend payments from a Dutch corporation to Compaq should be treated as a tax rather than as an expense for purposes of the pre-tax-profit analysis. Compaq bought American Depository Receipts (ADRs) in Royal Dutch Petroleum Company and shortly thereafter sold the ADRs at a loss of approximately $20.7 million. *Id*. at 780. Royal Dutch declared a dividend while Compaq was the shareholder of record, entitling Compaq to a dividend of approximately $22.5 million. Royal Dutch paid that dividend to Compaq, less about $3.4 million in foreign withholding tax that Royal Dutch paid to the Netherlands government, so that Compaq received a net dividend of $19.1 million. *Id*. The Tax Court held the Dutch tax was "a cost of the transaction" resulting in a net loss of "roughly $1.5 million." *Id.* at 782.

The Fifth Circuit reversed, noting that the test the Tax Court applied discriminated between foreign and U.S. taxes. *Id*. at 785. The Fifth Circuit held the transaction had

economic substance because it was profitable apart from taxes once the Dutch tax properly was treated as a tax instead of as an expense:

> If the effects of the transaction are computed consistently, Compaq made both a pre-tax profit and an after-tax profit from the ADR transaction. Subtracting Compaq's capital losses from the gross dividend rather than the net dividend results in a net pre-tax profit of about $1.894 million. Compaq's U.S. tax on that net pre-tax profit was roughly $644,000. Subtracting $644,000 from the $1.894 million results in an after-tax profit of about $1.25 million. The transaction had economic substance.

Id. at 786. The Eighth Circuit had reached a similar result on similar facts in *IES Industries, Inc. v. United States,* 253 F.3d 350 (8th Cir. 2001).

The Federal Circuit disagreed (albeit without acknowledging the split) with the Fifth and Eighth Circuits in *Salem Fin., Inc. v. United States*, 786 F.3d 932 (Fed. Cir. 2015). That case involved a trust transaction in which BB&T paid $22 of U.K. tax for every $11 of income realized. The Federal Circuit held that the foreign tax should be treated as an expense, making the transaction "profitless" and therefore lacking economic substance. *Id.* at 949. In its decision below, the Second Circuit adopted the standard of the Federal Circuit and held "that foreign taxes are economic costs and should thus be deducted when calculating pre-tax profit." (A. 45a.) The court accordingly held that the foreign income taxes paid by AIG's portfolio companies on their investment income should be treated as expenses "and deducted from profit *before* calculating pre-tax profit." (A. 32a.) In summary, the court "agree[d] with the Federal Circuit in *Salem* and

disagree[d] with the decision of the Fifth and Eighth Circuits (*Compaq* and *IES*, respectively)." (A. 45a.)

C. Foreign Taxes Are Appropriately Treated as Taxes for Purposes of Determining Whether a Cross-Border Transaction Has Economic Substance

This Court should reverse the Second Circuit's decision because it upsets the equivalence of U.S. and foreign taxes in the U.S. foreign tax credit regime and will significantly impede cross-border investment, which would be contrary to the very purpose of the foreign tax credit. Congress enacted the foreign tax credit in 1918 "to mitigate the evil of double taxation" and to encourage foreign business transactions. *Burnet v. Chicago Portrait Co.*, 285 U.S. 1, 7 (1932); *see also Kraft Gen. Foods v. Iowa Dep't of Rev. & Fin.*, 505 U.S. 71, 73 (1992); *Goodyear Tire & Rubber Co.*, 493 U.S. at 139 (1989). Under the U.S. foreign tax credit regime (26 U.S.C. §§ 901 *et seq.*), a U.S. taxpayer engaging in a cross-border transaction subject to foreign income tax may claim (subject to various limitations) a dollar-for-dollar credit for the foreign tax paid. The credit is applied as an offset against the U.S. income tax otherwise due on the same transaction, with any excess offset against the taxpayer's U.S. tax on other foreign source income of a similar character.[4] This system essentially cedes taxing authority over foreign source

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[4] Given that U.S. taxpayers can claim only a dollar-for-dollar credit for foreign taxes paid or accrued, the foreign tax credit is not the typical tax "benefit" to which the courts traditionally have applied the economic substance test. It is undisputed that the transactions at issue caused AIG's worldwide tax liability to increase, and that AIG will suffer double taxation absent the foreign tax credit.

income to foreign jurisdictions and "in effect treats the taxes imposed by the foreign country as if they were imposed by the United States." H.R. Rep. No. 1337, 83rd Cong., 2d Sess. 76 (1954). In testing AIG's entitlement to a foreign tax credit in a manner that discriminates against foreign investment, the Second Circuit violated the foundational principle on which the foreign tax credit is based.

The Second Circuit's treatment of foreign income tax as an expense for purposes of the pre-tax profit test also is erroneous because it creates a mismatch with how foreign income tax is treated in computing U.S. gross income when foreign tax credits are claimed. AIG was required to report, and did report, all of the investment income earned by the portfolio companies in its U.S. gross income – *including* the portion that was used to pay foreign tax. 26 U.S.C. §§ 78, 951. There is no principled basis for treating foreign tax differently in computing pre-tax profit than how it is treated in computing U.S. gross income. To the contrary, the Fifth and Eighth Circuits both relied on the fact that the taxpayers in *Compaq* and *IES* were required to include the gross dividends (before payment of foreign tax) in their U.S. income to hold that the transactions had economic substance as a matter of law. *Compaq*, 277 F.3d at 783-84; *IES*, 253 F.3d at 354. As the Eighth Circuit put it: "Because the entire amount of the ADR dividend was income to IES, the ADR transactions resulted in a profit, an economic benefit to IES." *IES*, 253 F.3d at 354. AIG included in its U.S. gross income the foreign earnings it used to pay foreign tax, and it properly included those amounts in computing pre-tax profit for purposes of the economic substance test.

The test the Second Circuit adopted, in comparison, artificially excludes from the computation of pre-tax profit any foreign earnings that a U.S. taxpayer uses to pay foreign tax. That application of the test loses sight of the purpose of the test. The pre-tax profit test is only a tool to

aid a court in determining "whether what was done . . . was the thing which the statute intended." *Gregory*, 293 U.S. at 469. The Second Circuit, however, like some other lower courts, has imposed "economic substance" as a requirement unmoored to the purpose of the statute. That short-sightedness led the court to treat foreign tax as an expense notwithstanding that such treatment conflicts with the fundamental architecture of the foreign tax credit regime and with far more basic concepts of gross income.

The conflict between the Second and Federal Circuits and the Fifth and Eighth Circuits on the question here presented, as well as the erroneous Second Circuit analysis, compels this Court's review at this time.

D. Recent Legislation Makes Resolution of the Issue of the Appropriate Treatment of Foreign Taxes in Cross-Border Transactions Even More Important to U.S. Taxpayers

Congress codified the economic substance test in 2010. *See* 26 U.S.C. § 7701(o). That provision is effective for transactions entered into after March 30, 2010, and therefore does not apply in this case. Nevertheless, Congress' codification of the test makes it even more important that this Court resolve the issue presented in this Petition, as Congress acknowledged the import of the pre-tax profit test in enacting a "special rule" to govern its computation. *Id.* § 7701(o)(2)(A). The new statute does not answer whether a foreign income tax is properly treated as an expense for purposes of determining entitlement to a foreign tax credit. (The statute directs the Secretary of the Treasury to "issue regulations requiring foreign taxes to be treated as expenses in appropriate cases," *id.* § 7701(o)(2)(B), but the Secretary has not issued those regulations and there is nothing to indicate whether any such regulations would treat foreign income taxes – as

opposed to other types of foreign tax – as expenses or whether that treatment would apply when a foreign tax credit is at issue. The statute thus underscores the sweeping implications and misplaced policy of the Second Circuit's decision, which identifies foreign taxes as "economic costs" for all foreign transactions (A. 46a) – a result that Congress clearly did not intend.)

II. THE ISSUE PRESENTED IS FUNDAMENTALLY IMPORTANT TO EVERY U.S. TAXPAYER THAT RELIES ON THE FOREIGN TAX CREDIT TO ALLEVIATE DOUBLE TAXATION

The approach the Second Circuit adopted not only is legally erroneous, but also calls into question a wide range of routinely conducted cross-border business transactions and conflicts with Congress' intent on that further basis. The Second Circuit's decision that foreign income taxes are to be treated as expenses for purposes of determining pre-tax profit discriminates against foreign investment in contravention of U.S. tax policy.

In recent years the lower courts have treated the economic substance doctrine as a "trump card; even if a transaction complies precisely with all requirements for obtaining a deduction, if it lacks economic substance it simply is not recognized for federal taxation purposes, for better or for worse." *In re CM Holdings, Inc.*, 301 F.3d 96, 102 (3d Cir. 2002). As a result, taxpayers must consider the "economic substance doctrine" when planning transactions, just as they consider the Code and Treasury regulations.[5]

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[5] Congress' codification of the doctrine, as noted, makes this a certainty for transactions taking place after March 30, 2010.

Given the Second Circuit's decision in the context of such precedent, consider a simple example. A U.S. taxpayer borrows $1000 domestically at a rate of 3.0 percent and lends the funds to a U.S. borrower at a rate of 4.0 percent (that is, the taxpayer, like AIG-FP in this case, is engaging in spread banking). Its borrowing cost is thus $30 per year and it anticipates earning interest income of $40 per year, for a net profit of $10 before taxes. This transaction clearly would satisfy the "pre-tax profit" test and therefore be considered to have economic substance.

Assume instead, however, that the taxpayer lends the money to a foreign borrower and the borrower's country (like the U.S.) imposes a 30 percent statutory withholding tax on outbound interest payments. In that case, the taxpayer would have $12 withheld from the interest payment due and would receive only $28 of interest from the borrower. Under U.S. tax rules, however, the taxpayer would be required to report $40 of interest income because it earned $40. The taxpayer's pre-tax profit therefore again should be recognized as $10 ($40 of interest income less $30 of borrowing costs), and it should be allowed to claim a foreign tax credit for the $12 of foreign withholding tax imposed on it.

Under the Second Circuit's holding, however, the taxpayer would be required to treat the $12 of foreign withholding tax as an additional "expense" incurred in the transaction, thereby increasing its total expenses from $30 to $42 and causing the transaction to show a "pre-tax loss" of $2 for economic substance purposes ($42 in expenses less $40 in income), even though the taxpayer would still report $10 of net income for U.S. tax purposes. Showing a "pre-tax loss" for economic substance purposes could cause the taxpayer to lose its ability to claim a credit for the $12 of foreign taxes that it incurred. That risk, which does not exist in the domestic transaction, obviously would influence the taxpayer's decision whether to engage in the

cross-border version of the same transaction, contrary to the fundamental purpose of the foreign tax credit regime.

Under this example, the difference between the tests employed by the Fifth and Eighth Circuit ($30 of expenses), versus the one the Second Circuit adopted ($30 of expenses + $12 of foreign tax = $42 of "expenses"), is easily illustrated:

	U.S. Tax Consequences of Domestic Loan	Pre- and After-Tax Profit of Foreign Loan in Fifth and Eighth Circuits	Pre- and After-Tax Profit of Foreign Loan in Second Circuit
Income	40.00	40.00	40.00
Expense	(30.00)	(30.00)	(42.00)
Pre-tax income	**10.00**	**10.00**	**(2.00)**
Foreign tax	–	(12.00)	
U.S. tax (35%)	(3.50)	(3.50)	(3.50)
Foreign tax credit	–	12.00*	
After-tax income	**6.50**	**6.50**	**(5.50)**

* This example assumes that the taxpayer that lends the funds to a foreign borrower will be able to use the entire foreign tax credit to offset the U.S. tax that would be due on other foreign source income.

In short, including the foreign tax as an expense in computing pre-tax income would make most foreign investments look like they lack economic substance and thus disqualify them from a foreign tax credit, a far cry from the purpose of treating "the taxes imposed by the

foreign country as if they were imposed by the United States." H.R. Rep. No. 1337, *supra*.

In the aftermath of the Second Circuit and Federal Circuit decisions, taxpayers engaging in any number of cross-border transactions (like the one in the example) are faced with great uncertainty as to whether their particular transactions would satisfy the pre-tax profit test if challenged by the IRS. Indeed, the facts in the example need only be slightly revised to reflect AIG's transactions that the IRS did challenge.

The discriminatory nature of the Second Circuit test is especially relevant in this case. Although the Second Circuit conspicuously did not address the issue (which AIG briefed in some detail), AIG also borrowed funds from foreign banks through repurchase transactions that were identical in all material respects to the transactions here at issue except that the portfolio companies were domiciled in the United States rather than in foreign countries and therefore paid U.S. tax rather than foreign tax on their investment income.

The IRS never challenged those domestic transactions on economic substance grounds, or any other grounds. Instead, the IRS challenged only those of AIG's transactions that were subject to foreign income taxes. Challenging transactions of this type only when they involve foreign income taxes for which foreign tax credits may be claimed undercuts Congress' entire purpose in establishing the foreign tax credit regime, which was to neutralize the effect of foreign tax on a taxpayer's choice of business locale. And absent the foreign tax credit, AIG would have a strong incentive *always* to domicile the portfolio company in the United States, so that its income would be taxed only once.

The issue here presented might arise in connection with any cross-border business transaction. Taxpayers should not have to be concerned about whether they are vulnerable to an economic substance challenge and the

resulting possibility of double taxation whenever they choose to engage in a cross-border transaction, and incur foreign income tax, rather than engage in a domestic transaction of the same type. Given the conflict among the Circuits and the fact that the question is an important and recurring one for U.S. taxpayers engaging in international commerce, this Court's resolution of the issue at this time is essential to eliminate the continuing uncertainty and confusion that otherwise will exist regarding this fundamental doctrine of tax law.

The significant extent (and intensity) of the tax commentary regarding the critical aspects of the case underscores the importance of the questions at issue and the need for clarity. Tax commentators have addressed in detail (1) the soundness of the decisions in *Compaq* and *IES*, *see, e.g.*, Kevin Dolan, *The Foreign Tax Credit Diaries – Litigation Run Amok*, 71 Tax Notes 895, 905-07 (Aug. 26, 2013); Robert H. Dilworth, *The Sky Is Not Falling After Compaq: The Business Purpose Doctrine Is Alive and Well in the Fifth Circuit*, 793 PLI/Tax 323, 338 (2007); James M. Peaslee, *Creditable Foreign Taxes and the Economic Substance Profit Test*, 114 Tax Notes 443 (Jan. 29, 2007); William A. Klein & Kirk J. Stark, *Compaq v. Commissioner – Where Is the Tax Arbitrage?*, 94 Tax Notes 1335, 1340 (Mar. 7, 2002); Marc D. Teitelbaum, *Compaq Computer and IES Industries – The Empire Strikes Back*, 86 Tax Notes 829, 836 (Feb. 7, 2000); and (2) the unsoundness of the district court's decision in this case, *see, e.g.*, Dolan, *Litigation Run Amok*, *supra*; Richard Lipton, *BNY and AIG – Using Economic Substance to Attack Transactions the Courts Do Not Like*, 119 J. Tax'n 40 (July 2013); Jason Yen & Patrick Sigmon, *District Court's "AIG" Ruling Expands Application of Economic Substance Doctrine in Unexpected Ways for Transactions Generating Excess Foreign Tax Credits*, Daily Tax Report (May 5, 2013). Accordingly, even apart from endorsing the principles that support AIG in this case, such commentary

frames the Second Circuit's decision as among the "recent rash of economic substance cases" that turn on interpretation of *Compaq* and *IES*, and that in doing so create "new and significant complication for taxpayers." Yes & Sigmon, *supra*.

III. THIS CASE PRESENTS THE MOST SUITABLE OPPORTUNITY FOR THE COURT TO RESOLVE THE CIRCUIT SPLIT AT ISSUE

The question of whether to treat foreign taxes as an expense also arises in the petition for certiorari filed by Salem Financial, Inc. *See Salem Fin., Inc. v. United States*, 786 F.3d 932 (Fed. Cir. 2015), petition for cert. pending, No. 15 - ___ (filed September 29, 2015). In addition, in the case resolved in tandem with this case, The Bank of New York Mellon Corporation may choose to file a petition for certiorari. AIG respectfully submits that this case presents the most suitable opportunity for the Court to resolve the Circuit split at issue, because (1) this is the only case in which the material facts are undisputed (one of the reasons the case was certified for appeal to the Second Circuit), whereas the petition filed by BB&T makes factual assertions that appear to conflict with findings made in the lower court; (2) the borrowing transactions at issue in this case are far more straightforward than the complicated "STARS" transactions at issue in each of the *Salem Financial* and *Bank of New York Mellon* cases, and thus more squarely present the legal question at issue; and (3) whereas the Federal Circuit in *Salem Financial* declined to acknowledge the Circuit split its decision created, the Second Circuit did acknowledge and discuss that its decision reflected a split – and in doing so articulated a general rule identifying foreign taxes as "economic costs" for all foreign transactions (A. 46a) – and thus more directly framed the issue for this Court to resolve.

CONCLUSION

The Second Circuit's decision to treat the payment of foreign taxes as an expense in applying the economic substance doctrine conflicts with the decisions of the Fifth and Eighth Circuits. The decision also leaves intact the effective imposition of double taxation on a U.S. taxpayer and discriminates against foreign investment – precisely the outcomes that Congress created the foreign tax credit to avoid. The Court should provide guidance on this issue to resolve the Circuit split and to clarify an issue that is a critical factor for any U.S. taxpayer contemplating any of a wide array of cross-border transactions. For the foregoing reasons, the Petition for a Writ of Certiorari should be granted.

Respectfully submitted,

David Boies
Robin Henry
Edward Normand
BOIES, SCHILLER & FLEXNER LLP
333 Main Street
Armonk, New York 10504
(914) 749-8200
dboies@bsfllp.com

Thomas A. Cullinan
SUTHERLAND ASBILL & BRENNAN LLP
999 Peachtree Street, N.E.
Atlanta, Georgia 30309
(404) 853-8000

Jerome B. Libin
Daniel H. Schlueter
SUTHERLAND ASBILL & BRENNAN LLP
700 Sixth St., NW #700
Washington, DC 20001
(202) 383-0100

Appendix

APPENDIX A — JUDGMENT OF THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT, FILED SEPTEMBER 9, 2015

UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

At a Stated Term of the United States Court of Appeals for the Second Circuit, held at the Thurgood Marshall United States Courthouse, 40 Foley Square, in the City of New York, on the 9th day of September, two thousand and fifteen.

Before: José A. Cabranes,
Reena Raggi,
Denny Chin,
*Circuit Judge*s.

Docket Nos. 14-704(L)
14-1394(XAP)

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

Petitioner-Appellant-Cross-Appellee,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee-Cross-Appellant.

Appendix A

Docket No. 14-765

AMERICAN INTERNATIONAL GROUP, INC.,

Plaintiff-Appellant,

v.

UNITED STATES OF AMERICA,

Defendant-Appellee.

The appeals and cross-appeal in the above captioned cases from a judgment of the United States Tax Court and an opinion and order of the United States District Court for the Southern District of New York were argued on the district court's record and the parties' briefs. Upon consideration thereof,

IT IS HEREBY ORDERED, ADJUDGED and DECREED that the decisions of the district court and Tax Court are AFFIRMED.

For The Court:

Catherine O'Hagan Wolfe,
Clerk of Court
/s/_____

APPENDIX B — ORDER OF THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT, DECIDED SEPTEMBER 9, 2015

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

August Term 2014

(Argued: May 18, 2015 Decided: September 9, 2015)

Docket Nos. 14-704-ag(L), 14-1394-ag(XAP), 14-765-cv

THE BANK OF NEW YORK MELLON CORPORATION, as Successor in Interest to THE BANK OF NEW YORK COMPANY, INC.,

Petitioner-Appellant-Cross-Appellee,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee-Cross-Appellant.

AMERICAN INTERNATIONAL GROUP, INC.,

Plaintiff-Appellant,

Appendix B

v.

UNITED STATES OF AMERICA,

Defendant-Appellee.

ON APPEAL FROM THE UNITED STATES TAX COURT AND THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK

Before:

CABRANES, RAGGI, and CHIN, *Circuit Judges*.

Appeals and cross-appeal heard in tandem from a judgment of the United States Tax Court (Kroupa, *J.*) and an opinion and order of the United States District Court for the Southern District of New York (Stanton, *J.*) applying the "economic substance doctrine" to transactions involving foreign tax credits. The Tax Court considered the effect of foreign taxes in its pre-tax analysis and denied the claimed foreign tax credits as lacking economic substance, but allowed interest expense deductions for the loan associated with the transactions. The district court held that the economic substance doctrine applies to transactions involving foreign tax credits generally and that foreign taxes are to be included in calculating pre-tax profit.

AFFIRMED.

CHIN, *Circuit Judge*:

Appendix B

These appeals and cross-appeal, heard in tandem, challenge an opinion and order of the United States District Court for the Southern District of New York (Stanton, *J.*) and a judgment of the United States Tax Court (Kroupa, *J.*) applying the "economic substance doctrine" to transactions involving foreign tax credits. In both cases, the taxpayers claim they are entitled to tax credits associated with foreign transactions that the government disallowed because it contends the transactions lacked economic substance.

In *American International Group., Inc. v. United States*, in which American International Group ("AIG") seeks a tax refund of $306.1 million, the district court held that: 1) the economic substance doctrine applies to the foreign tax credit regime; and 2) the pre-tax benefit that AIG gained from its "cross-border" transactions is to be calculated by taking into account foreign taxes. Accordingly, the district court denied AIG's motion for partial summary judgment. It certified the matter for interlocutory appeal.

In *Bank of New York Mellon Corp. v. Commissioner*, which involves alleged tax deficiencies of some $215 million, the Tax Court held a three-week bench trial on the economic substance of the Structured Trust Advantaged Repackaged Securities loan product ("STARS") purchased by Bank of New York Mellon ("BNY"). The Tax Court held: 1) the effect of foreign taxes is to be considered in the pre-tax analysis of economic substance; and 2) STARS lacked economic substance, and thus BNY could not claim foreign tax credits associated with STARS. The

Tax Court further held that certain income from STARS was includible in BNY's taxable income and BNY was not entitled to deduct interest expenses associated with STARS, but reversed both rulings on reconsideration.

We hold that the economic substance doctrine applies to the foreign tax credit regime generally, and that both the district court and Tax Court properly determined the tax implications of the cross-border and STARS transactions. Accordingly, we affirm.

STATEMENT OF THE CASE

A. *The Foreign Tax Credit Regime*

Various provisions of the Internal Revenue Code (the "Code") seek "to mitigate the evil of double taxation." *Burnet v. Chi. Portrait Co.*, 285 U.S. 1, 7, 52 S. Ct. 275, 76 L. Ed. 587, 1932 C.B. 286, 1932-1 C.B. 286 (1932). The Code taxes all income of U.S. taxpayers earned worldwide. 26 U.S.C. § 61(a). Because this can result in double taxation of a U.S. taxpayer's income earned abroad -- by the country in which it was earned as well as the United States -- Congress crafted the "foreign tax credit" regime.

First established by the Revenue Act of 1918, the foreign tax credit regime was intended to facilitate business abroad and foreign trade. *See* 56 Cong. Rec. app. 677 (1918) (statement of Rep. Kitchin) ("We would discourage men from going out after commerce and business in different countries . . . if we maintained this double taxation."). Under the regime, when a U.S.

taxpayer pays income tax to another country due to its business activities in that country, the taxpayer can claim a dollar-for-dollar credit against its U.S. tax liability for the foreign taxes paid. 26 U.S.C. §§ 901-909. This "foreign tax credit" then mitigates double taxation by offsetting the taxpayer's U.S. taxable income and reducing its overall tax bill. The foreign tax credit regime does not, however, require a taxpayer "to alter its form of doing business, its business conduct, or the form of any business transaction in order to reduce its liability under foreign law for tax." 26 C.F.R. § 1.901-2(e)(5)(i).

As relevant to the instant cases, the Code deems taxes paid by foreign subsidiaries to be paid by their U.S. parent companies. 26 U.S.C. §§ 902, 960. Thus, in a given tax year, a U.S. corporation can claim a "foreign tax credit" in the same amount as the foreign taxes paid by its foreign subsidiary, reducing its total U.S. taxable income.

"Entitlement to foreign tax credits[, however,] is predicated on a valid transaction." 12 Mertens Law of Federal Income Taxation § 45D:62. To be "valid" and not just a "sham," a transaction must involve more than just tax benefits: it must have independent economic substance. *See DeMartino v. Comm'r*, 862 F.2d 400, 406 (2d Cir. 1988) ("A transaction is a sham if it is fictitious or if it has no business purpose or economic effect other than the creation of tax deductions."). Accordingly, as we discuss below, a court can hold that a taxpayer is not entitled to certain deductions or other tax benefits where it finds that the underlying transaction lacks "economic substance" beyond its tax benefits.

Appendix B

B. *American International Group, Inc. v. United States*

1. *The Facts*

As AIG acknowledges, the facts relevant to this appeal are largely undisputed.[1] To the extent that there is dispute, we construe the facts in the light most favorable to the non-moving party, the government:

Between 1993 and 1997, AIG entered into six cross-border transactions with foreign financial institutions through its subsidiary, AIG Financial Products ("AIG-FP").[2] Through these transactions, AIG-FP borrowed funds at economically favorable rates below LIBOR and invested the funds at rates above LIBOR, ostensibly to make a profit.[3]

---

1. The government never moved for summary judgment below and contends on appeal that a trial is necessary because genuine issues of material fact exist with respect to whether the cross-border transactions have economic substance.

2. The names of the disputed transactions and their dates and counterparties are: "Laperouse," entered September 30, 1993 with Credit Agricole; "Vespucci," entered December 18, 1995 with Banca Commerciale Italiana; "NZ Issuer" or "New Zealand," entered December 11-19, 1996 with Bank of New Zealand; "Maitengrove," entered February 28, 1997 with Bank of Ireland; "Lumagrove," entered August 27, 1997 with Bank of Ireland; and "Palmgrove," entered October 20, 1997 with Irish Permanent.

3. LIBOR stands for "London Interbank Offered Rate" and is the benchmark rate that many banks charge each other for short-term loans. *See Carpenters Pension Tr. Fund of St. Louis v. Barclays PLC*, 750 F.3d 227, 229, 230 n.2 (2d Cir. 2014).

Appendix B

Each cross-border transaction operated as follows. First, AIG-FP created and funded a foreign affiliate -- a special purpose vehicle ("SPV") -- to hold and invest funds in a foreign country. Next, AIG-FP sold the SPV's preferred shares to a foreign lender bank and committed to repurchase the preferred shares on a specific future date at the original sale price. The SPV's capital was thus primarily comprised of the funds the foreign bank paid for the preferred stock, as well as a smaller contribution from AIG. The SPV then used this capital to purchase investments, earning income for which the SPV paid taxes to the relevant foreign authority. The SPV then paid most of the net proceeds of this investment income to the foreign bank as dividends.

For U.S. tax purposes, AIG claimed that it owned all of the shares of the SPV and thus treated the foreign bank's funds for the purchase of the preferred shares as a loan. AIG then deducted the dividends paid by the SPV to the foreign banks as interest expense. AIG also claimed foreign tax credits for the full amount of the foreign taxes paid by each SPV on the pre-dividend investment income. Accordingly, on its 1997 U.S. tax return, AIG reported total gross income from the cross-border transactions of $128.2 million from which it deducted $71.9 million in interest expenses, for a net taxable income of $56.3 million. Based on the corporate tax rate of 35%, AIG owed $19.7 million in taxes on the cross-border transactions. But AIG also claimed $48.2 million in foreign tax credits for the foreign taxes paid by the SPVs on total income, which it then used to offset U.S. tax not only on its $19.7 million U.S. tax obligation for the cross-border transaction, but also on some $28.5 million in unrelated income.

At the same time, each foreign bank reported to the relevant foreign revenue authority that it owned the preferred stock as an equity investment in the SPV. As a result, for foreign tax purposes, the SPV was treated as the foreign bank's corporate subsidiary. Accordingly, instead of treating the SPV's distribution to the foreign bank as taxable interest on a loan to AIG, the foreign bank claimed the payments as tax-exempt dividends on which it paid little, if any, tax. Instead, the SPV paid tax on the SPV's income to the relevant foreign authorities. The foreign bank then shared these tax benefits with AIG-FP by accepting a lower dividend rate than it would have otherwise demanded if its investment income were taxable

This arrangement effectively reduced AIG's total tax bill. It also allowed the foreign banks to limit their tax liability, inducing them to accept lower return rates from AIG. Thus, AIG effectively converted 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 and reduce its total U.S. tax bill.

AIG claims that the cross-border transactions had economic substance because they were expected to generate a pre-tax profit of at least $168.8 million for AIG over the life of the transactions. To reach this number, AIG calculated pre-tax profit by taking the SPV's investment income and subtracting only AIG's operating expenses and obligations to the foreign banks. Thus, in calculating pre-tax profit, AIG ignored: 1) the foreign tax paid by the SPV; 2) the U.S. tax paid by AIG on the SPV's investment income; and 3) the value of the foreign tax credits claimed by AIG.

2. *Proceedings Below*

On March 20, 2008, the 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. On July 8, 2008, the IRS assessed the additional amounts, which AIG paid on August 1, 2008. On August 25, 2008, AIG filed a claim for refund for the amounts paid, claiming they were erroneously assessed by the IRS. On February 27, 2009, because the IRS had not rendered a decision on its refund claim, AIG filed a complaint in the district court seeking a refund of $306.1 million in federal income taxes assessed by the IRS and paid by AIG for its 1997 taxable year.

On July 30, 2010, AIG moved for partial summary judgment, arguing that it was entitled, as a matter of law, to foreign tax credits for the income taxes paid to other countries by its subsidiaries. AIG argued that: 1) the economic substance doctrine does not apply to the foreign tax credit regime; and 2) even if the doctrine does apply, the relevant transactions had economic substance because they resulted in $168.8 million in pre-tax profit. On March 29, 2011, the district court denied AIG's motion without prejudice, concluding that the government had demonstrated the need for more discovery. After the close of fact discovery but before the start of expert discovery, AIG renewed its motion for partial summary

judgment on August 1, 2012, limited to the six cross-border transactions.

On March 29, 2013, the district court issued an opinion and order denying AIG's renewed motion for partial summary judgment. The district court held that: 1) the economic substance doctrine applies to the foreign tax credit regime because Congress intended foreign tax credits to facilitate only "purposive" business transactions; and 2) foreign taxes are to be included as a cost in the calculation of pre-tax benefit from the cross-border transactions. Accordingly, the district court denied AIG's motion for partial summary judgment. *Am. Int'l Grp., Inc. v. United States*, No. 09 Civ. 1871(LLS), 2013 U.S. Dist. LEXIS 45871, 2013 WL 1286193 (S.D.N.Y. Mar. 29, 2013).

On November 5, 2013, the district court certified its March 29, 2013 opinion and order for interlocutory appeal under 28 U.S.C. § 1292(b). On November 15, 2013, AIG timely filed a petition in this Court for permission to appeal under Federal Rule of Appellate Procedure 5(a)(2). On March 19, 2014, we granted the petition, and this appeal followed.

C. *Bank of New York Mellon v. Commissioner*

1. *The Facts*

We accept the facts as found by the Tax Court at trial unless clearly erroneous. *See Banker v. Nighswander, Martin & Mitchell*, 37 F.3d 866, 870 (2d Cir. 1994).

Appendix B

In 2001, Barclays Bank, PLC -- a global financial services company headquartered in London, United Kingdom -- and KPMG -- an audit, tax, and advisory firm -- started promoting a loan product they called "Structured Trust Advantaged Repackaged Securities" or "STARS" to U.S. banks. In marketing STARS to U.S. banks, KPMG explained that a U.K. counterparty -- here Barclays -- would offer a "below market loan," the low cost of which would be achieved through the "sharing" of certain U.K. and U.S. tax benefits generated by the creation of a trust subject to U.K. taxation. BNY entered into STARS transactions with Barclays in November 2001, and the transactions continued until 2006.

We assume familiarity with the Tax Court's opinion below, which describes the structure of STARS in detail. The basic operation of the STARS transactions can be summarized as follows. First, BNY created a Delaware trust to which it contributed $7.8 billion in income-producing assets. In exchange for this contribution, BNY received nominal shares in the trust (class A and B units). BNY agreed to install a U.K. resident as the trustee, so the trust's income would be subject to U.K. taxation. BNY then paid tax on the trust to the United Kingdom, and, in exchange, Barclays agreed to pay BNY a monthly amount equal to half of the U.K. taxes BNY expected to pay on the trust's income -- the so-called "tax-spread."

Next, Barclays purchased shares in the trust (class C and D units) for $1.5 billion, effectively making a loan in that amount to BNY for the duration of STARS through the trust structure. BNY agreed to repay the loan by

purchasing Barclay's trust units for approximately $1.5 billion at the end of five years. The monthly interest rate on the loan was equal to one-month LIBOR plus 30 basis points, minus the aforementioned monthly tax-spread. Under this structure, Barclays made total net monthly payments to BNY of $82.6 million over the life of STARS.

Throughout the five-year duration of the STARS transactions, the trust made monthly distributions of income via a circular, multi-step process. First, BNY distributed funds from its income-earning assets to the trust, and the trust set aside 22% of its income to pay U.K. taxes. With most of the remaining income,[4] the trust made monthly class C unit distributions to a Barclays account that was "blocked," meaning Barclays could not access the funds or control the account. Barclays immediately returned these distributions to the trust each month, and the trust then distributed the funds to BNY, beginning the cycle again.

The resulting tax benefits to both BNY and Barclays from STARS can be illustrated by tracing a hypothetical $100 of trust income through the distribution cycle (ignoring fees and the smaller class A, B, and D distributions). *See* BNY Appellant's Br. at 14-15; *Salem Fin., Inc. v. United States*, 786 F.3d 932, 938 (Fed. Cir. 2015) (employing similar hypothetical in reviewing STARS transaction). Under U.K. tax law, Barclays -- as owner of the class C units -- was deemed the owner of almost all of

4. Small quantities of the trust income were paid to BNY on the class A units (1% of trust income) and B units, to Barclays on the class D units, and towards other expenses.

the trust income and taxed at the 30% U.K. corporate tax rate, obligating it to pay $30 in tax for every $100 of trust income ($100 x 30%). Barclays would reduce this tax bill, however, by claiming a credit for the 22% U.K. tax on the trust, which was paid by BNY. Barclays' tax liability for the trust income was thus only $8 ($30 - $22). BNY, in turn, would claim a foreign tax credit in the United States for the full $22 it had paid in U.K. taxes on the trust's income.

The income distribution scheme compounded the tax benefits to both parties. Each month, for every $100 of trust income, the trust would set aside $22 to pay U.K. taxes, with $78 remaining for distribution. Because the $78 was first transferred to Barclays' blocked account and then back to the trust, Barclays could treat the re-contributed $78 as a trading loss and claim a trading loss deduction under U.K. tax law. At the 30% corporate tax rate, the deduction translated to a $23.40 reduction in Barclays' U.K. taxes ($78 x 30%). The deduction more than offset Barclay's $8 tax bill from the trust, resulting in a net tax benefit to Barclays of $15.40 ($23.40 - $8). Finally, Barclays would pay the $11 tax-spread to BNY -- half the trust's U.K. tax bill of $22. Because Barclays would deduct the cost of the tax-spread from its U.K. corporate taxes, it gained an additional $3.30 in tax benefit ($11 x 30%). In the end, this left Barclays with $7.70 in total tax benefit for each $100 of trust income ($15.40 minus the tax-spread payment of $11, plus the tax-spread deduction of $3.30).

BNY also enjoyed a net tax benefit. While it paid $22 in U.K. taxes, it was effectively reimbursed half this amount upon receipt of the $11 tax-spread from Barclays.

Neverthless, it claimed the full $22 as a foreign tax credit in the United States, for a total net gain of $11.

Meanwhile the United Kingdom and United States collected little to no tax revenue on STARS. For each $100 of trust income, the United Kingdom only collected $3.30 in net taxes ($22 in tax paid by BNY minus $18.70 ($15.40 + $3.30) in tax benefits to Barclays). The United States collected no taxes from STARS. Yet, for the tax years 2001 and 2002, BNY claimed foreign tax credits of $198.9 million and interest expense deductions of $7.6 million that offset its unrelated income and reduced its overall U.S. tax bill for these years.

2. *Proceedings Below*

On August 14, 2009, the IRS issued a Statutory Notice of Deficiency to BNY of $100.5 million for its 2001 taxes and $115 million for its 2002 taxes, disallowing foreign tax credits and interest expense deductions it had claimed for those years. On November 10, 2009, BNY petitioned the Tax Court for a re-determination of deficiencies. BNY did not contest that the economic substance doctrine applied to STARS but argued that STARS had economic substance, and that therefore it was entitled to the claimed credits and deductions.

The Tax Court held a three-week bench trial, and on February 11, 2013, issued an opinion holding that the STARS transactions were to be disregarded for U.S. tax purposes. *Bank of N.Y. Mellon Corp. v. Comm'r*, 140 T.C. 15 (2013). The court bifurcated its analysis of

the STARS trust structure and the $1.5 billion loan and found, in relevant part: 1) foreign taxes but neither loan proceeds nor the tax-spread should be considered in the pre-tax analysis of economic substance; 2) the STARS trust transaction lacked economic substance, as BNY had no purpose in entering the transaction except tax avoidance; 3) the tax-spread should be included in BNY's taxable income rather than considered a component of loan interest, as it served as a device to monetize anticipated foreign tax credits; and 4) all expenses incurred from the STARS transactions, including interest expenses from the $1.5 billion loan, were not deductible.

On March 12, 2013, BNY moved for reconsideration of the Tax Court's rulings with respect to the tax-spread as taxable income and interest expense deductions. On September 23, 2013, the Tax Court issued a supplemental opinion granting BNY's petition on these issues and held that 1) the tax-spread was not includible in BNY's income because it was part of the trust transaction that was disregarded for tax purposes for lacking economic substance; and 2) BNY was entitled to interest expense deductions because the $1.5 billion loan, bifurcated from the STARS trust transaction, had independent economic substance.

The Tax Court entered judgment on February 20, 2014. BNY appealed, and the IRS cross-appealed the Tax Court's interest expense deduction ruling on the $1.5 billion loan.

Appendix B

DISCUSSION

"The general characterization of a transaction for tax purposes is a question of law subject to review." *Frank Lyon Co. v. United States*, 435 U.S. 561, 581 n.16, 98 S. Ct. 1291, 55 L. Ed. 2d 550 (1978). We thus review the lower court's characterization of a transaction *de novo*, and where the lower court has made underlying factual findings, we review those findings for clear error. *See Jacobson v. Comm'r*, 915 F.2d 832, 837 (2d Cir. 1990); *Newman v. Comm'r*, 902 F.2d 159, 162 (2d Cir. 1990).

We review a district court's denial of a motion (or partial motion) for summary judgment *de novo*. *Doninger v. Niehoff*, 642 F.3d 334, 344 (2d Cir. 2011). "Summary judgment is proper only when, construing the evidence in the light most favorable to the non-movant, there is no genuine dispute as to any material fact and the movant is entitled to judgment as a matter of law." *Id.* (internal quotation marks omitted).

We address (a) the applicability of the economic substance doctrine to the foreign tax credit regime generally; (b) the economic substance of the transactions at issue in the instant cases; and (c) the deductibility of the interest expenses BNY paid on the $1.5 billion loan from Barclays.

A. *Applicability of the Economic Substance Doctrine to the Foreign Tax Credit Regime*

The "economic substance" doctrine is a common law rule that allows courts to question the validity of a transaction and deny taxpayers benefits to which they

are technically entitled under the Code if the transaction at issue lacks "economic substance." *See Gregory v. Helvering*, 293 U.S. 465, 468-70, 55 S. Ct. 266, 79 L. Ed. 596 (1935). The doctrine applies to "sham" transactions that "can not with reason be said to have purpose, substance, or utility apart from their anticipated tax consequences." *Goldstein v. Comm'r*, 364 F.2d 734, 740 (2d Cir. 1966).

AIG argues that the economic substance doctrine cannot be applied to disallow foreign tax credits that comply with all statutory and regulatory requirements.[5] AIG contends that because the congressional purpose of foreign tax credits -- to prevent double taxation -- is clear, a court should never be able to question a taxpayer's use of the credits under the economic substance doctrine. *See* AIG Appellant's Br. at 23-30; *cf. Estelle Morris Trs. v. Comm'r*, 51 T.C. 20, 43 (1968) (emphasizing need to limit doctrines like economic substance to "situations which they were intended to cover").

We disagree. First, the Supreme Court has long held that "substance rather than form determines tax consequences." *Raymond v. United States*, 355 F.3d 107, 108 (2d Cir. 2004) (quoting *Cottage Sav. Ass'n v. Comm'r*, 499 U.S. 554, 570, 111 S. Ct. 1503, 113 L. Ed. 2d 589 (1991) (Blackmun, *J.*, dissenting)) (internal quotation marks omitted); *see Comm'r v. Court Holding Co*, 324 U.S. 331, 334, 65 S. Ct. 707, 89 L. Ed. 981, 1945 C.B. 58 (1945). As

5. BNY did not raise this argument in the tax court and does not develop it on appeal. To the extent BNY contests the doctrine's general applicability to foreign tax credits, we reject the argument for the same reasons we reject AIG's argument.

we have recognized, the economic substance doctrine stems from the concern that "even if a transaction's form matches the dictionary definitions of each term used in the statutory definition of the tax provision, it does not follow that Congress meant to cover such a transaction and allow it a tax benefit." *Altria Grp., Inc. v. United States*, 658 F.3d 276, 284 (2d Cir. 2011) (internal quotation marks omitted).

Second, AIG misconstrues the purpose behind the economic substance doctrine. The economic substance doctrine exists to provide courts a "second look" to ensure that particular uses of tax benefits comply with Congress's purpose in creating that benefit. *See Gregory*, 293 U.S. at 469 (observing that, to assess economic substance, a court must look to the purpose of the statute to determine "whether what was done . . . was the thing which the statute intended"). It is entirely appropriate for a court to ask, therefore, whether a taxpayer's claim to foreign tax credits is tied to true "business abroad" resulting in actual out-of-pocket tax payments, or whether its claim to a tax credit derives from sham transactions devoid of a business purpose beyond exploiting differences among foreign tax codes. We have repeatedly acknowledged the applicability of the economic substance doctrine to various "sham" transactions. *See, e.g., Jacobson*, 915 F.2d at 837-38; *DeMartino v. Comm'r*, 862 F.2d 400, 406-07 (2d Cir. 1988); *Diggs v. Comm'r*, 281 F.2d 326, 329-30 (2d Cir. 1960). Further, under *Gregory*, "a taxpayer carr[ies] an unusually heavy burden" in seeking to show that anti-abuse doctrines like economic substance do not apply to the situation at hand. *Diggs*, 281 F.2d at 330.

Third, we find no support for the contention that foreign tax credits, by their nature, are not reviewable for economic substance. Congress's intent in creating foreign tax credits was to prevent double taxation of taxpayers conducting *business* in the United States and abroad. H.R. Rep. 83-1337, at 4103 (1954) ("The 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."). The legislative history thus focuses on taxpayers engaged in foreign business. Nothing in the history suggests that foreign tax credits are entitled to special immunity from scrutiny under the general economic substance doctrine, which allows a court to ask if a transaction really is "business" within the meaning of the Code. As we have emphasized, the foreign tax credit is designed only for the taxpayer who "desires to engage in *purposive* activity," not sham transactions built solely around tax arbitrage. *See Goldstein*, 364 F.2d at 741 (emphasis added).

Fourth, recent amendments to the Code and its regulations -- while not applicable to the instant cases, which predate these changes -- support our interpretation of Congress's intent regarding economic substance. In 2010, Congress codified the economic substance doctrine into the Code, recognizing that "[a] strictly rule-based tax system cannot efficiently prescribe the appropriate outcome of every conceivable transaction that might be devised and is, as a result, incapable of preventing all unintended consequences." H.R. Rep. 111-443, pt. 1, at 295 (2010). This provision codified the two-part economic substance test used in many Circuits, including ours, and affirmed decades of judge-made law from around

the country on economic substance. It did not create categorical exceptions to the doctrine, for foreign tax credits or otherwise.

Further, the Treasury Department issued new regulations (proposed in 2007, finalized in 2011) disallowing foreign tax credits associated with STARS and other similarly convoluted transactions designed to take advantage of foreign tax credits. Because the regulations are not retroactive, their preamble addressed the problem of already existing STARS: "For periods prior to the effective date of final regulations, the IRS will continue to utilize all available tools under current law to challenge the U.S. tax results claimed in connection with such arrangements, including . . . the economic substance doctrine . . . ." Determining the Amount of Taxes Paid for Purposes of Section 901, 72 Fed. Reg. 15,081, 15,084 (Mar. 30, 2007). These amendments reflect both Congress's recognition of the economic substance doctrine generally and its concern for potential abuse of foreign tax credits.

We thus hold that the economic substance doctrine can, as a general matter, be applied to disallow foreign tax credits.

B. ***Economic Substance Analysis***

We turn to the transactions at issue in AIG and BNY and evaluate them under our Circuit's test for economic substance.

Appendix B

1. *Applicable Law*

In determining whether a transaction lacks "economic substance," we consider: 1) whether the taxpayer had an objectively reasonable expectation of profit, apart from tax benefits, from the transaction; and 2) whether the taxpayer had a subjective non-tax business purpose in entering the transaction. *See Gilman v. Comm'r*, 933 F.2d 143, 147-48 (2d Cir. 1991). In our Circuit the test is not a rigid two-step process with discrete prongs; rather, we employ a "flexible" analysis where both prongs are factors to consider in the overall inquiry into a transaction's practical economic effects. *See id.* at 148; *Altria Grp., Inc. v. United States*, 694 F. Supp. 2d 259, 282 (S.D.N.Y. 2010), *aff'd*, 658 F.3d 276; *Long Term Capital Holdings v. United States*, 330 F. Supp. 2d 122, 171 (D. Conn. 2004), *aff'd*, 150 F. App'x 40 (2d Cir. 2005) (summary order).[6] "[A] finding of either a lack of a business purpose other than tax avoidance or an absence of economic substance beyond the creation of tax benefits can be but is not necessarily

6. It has been suggested that there is some confusion in our Circuit regarding whether our test for economic substance is a "flexible" two-part inquiry where neither factor is dispositive, or whether a taxpayer can show either an objective economic effect *or* a subjective business purpose to demonstrate economic substance. *See TIFD III-E Inc. v. United States*, 342 F. Supp. 2d 94, 108-09 (D. Conn. 2004), *rev'd on other grounds*, 459 F.3d 220 (2d Cir. 2006) (highlighting "ambiguity" that "decisions in this circuit are not perfectly explicit on the subject," but declining to decide which test applies). We have, however, consistently applied the flexible approach. *See Gilman*, 933 F.2d at 148.

sufficient to conclude the transaction a sham." *Long Term Capital Holdings*, 330 F. Supp. 2d at 171.[7]

The preliminary step of the economic substance inquiry is to identify the transaction to be analyzed. Even if the transaction at issue is part of a larger series of steps, "[t]he relevant inquiry is whether the transaction that generated the claimed deductions . . . had economic substance." *Nicole Rose Corp. v. Comm'r*, 320 F.3d 282, 284, 52 Fed. Appx. 545 (2d Cir. 2003); *see Long Term Capital Holdings*, 330 F. Supp. 2d at 183 (holding that a taxpayer "cannot avoid the requirements of economic substance simply by coupling a routine economic transaction generating substantial profits and with no inherent tax benefits to a unique transaction that otherwise has no hope of turning a profit").

After isolating the relevant transaction, we begin our analysis of economic substance by determining the objective economic substance of the transaction at issue. We then look to the taxpayer's subjective business purpose in entering the transaction. Finally, we consider

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7. Congress codified the economic substance doctrine in 2010, explicitly adopting a version of the two-part test: "In the case of any transaction to which the economic substance doctrine is relevant, such transaction shall be treated as having economic substance only if -- (A) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and (B) the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction." 26 U.S.C. § 7701(o)(1). Because the provision is not retroactive, the Code's test does not apply in these cases.

both the objective and subjective analysis to make a final determination of economic substance. *See Gilman*, 933 F.2d at 148.

a. *Objective Economic Substance*

The focus of the objective inquiry is whether the transaction "offers a reasonable opportunity for economic profit, that is, profit exclusive of tax benefits." *Gilman*, 933 F.2d at 146 (internal quotation marks omitted). As relevant here, our Circuit has yet to determine how profit should be calculated when a transaction involves foreign tax credits. The question is whether, for purposes of the economic substance doctrine, foreign taxes should be treated as costs when calculating pre-tax profit. If the answer is yes, then a transaction will be less likely to appear profitable under the objective prong of the economic substance test.

Other Circuits have taken disparate approaches. In *Salem Financial, Inc. v. United States*, a case involving the same STARS transactions at issue in *BNY*, the Federal Circuit concluded that foreign taxes are economic costs that are properly deducted in assessing profitability for the purposes of economic substance. There, as with BNY here, the court determined that for every $100 of trust income, the bank incurred $22 of foreign tax expense and only $11 in income from the tax-spread, for an $11 net loss. 786 F.3d at 946-49. The court also excluded foreign tax credits from the profit calculation, observing that "[o]ur precedent, like that of several other courts, supports the government's approach, i.e., to assess a transaction's economic reality, and in particular its profit

potential, independent of the expected tax benefits." *Id.* at 948. Because the Federal Circuit included foreign tax costs -- but excluded any foreign tax benefits -- in its calculation of pre-tax profit, the court concluded that the trust transaction in STARS was "profitless." *Id.* at 949.

The Federal Circuit held, however, that this lack of post-foreign-tax profit did not conclusively establish that a transaction lacks objective economic substance. *Id.* at 950. The Court ultimately held that STARS lacked objective economic substance, based on both the lack of post-foreign-tax profit and on the circular cash flows through the trust whose only purpose was generating tax benefits. *Id.* at 950-51.[8] Indeed, the court recognized that, as a result, the U.S. taxpayer was reimbursed for half the U.K. tax it had paid by a U.K. STARS counterparty who could claim foreign tax benefits that significantly reduced the net revenues realized by the U.K. from STARS. *See id.* Thus, the scheme was not objectively profitable and there was no real risk of *double* taxation, the purpose for which U.S. law afforded a foreign tax credit.

In factually different contexts, the Fifth and Eighth Circuits have taken a different approach to assessing

8. Barclays entered into STARS transactions with six U.S. banks, and two other cases addressing the economic substance of STARS are pending. *Santander Holdings USA, Inc. v. United States*, 977 F. Supp. 2d 46, 53 (D. Mass. 2013) (holding that STARS had economic substance) (other claims still pending, including the government's alternative arguments for disallowing the tax benefits of STARS); *Wells Fargo & Co. v. United States*, No. 09-cv-2764 (D. Minn.) (currently conducting pre-trial motions).

objective economic substance, holding that foreign taxes are not economic costs and should not be deducted from pre-tax profit. *Compaq Comput. Corp. & Subsidiaries v. Comm'r*, 277 F.3d 778 (5th Cir. 2001), *rev'g*, 113 T.C. 214 (1999); *IES Indus., Inc. v. United States*, 253 F.3d 350 (8th Cir. 2001), *rev'g*, No. C97-206, 1999 U.S. Dist. LEXIS 22610, 1999 WL 973538 (N.D. Iowa Sept. 22, 1999). In both cases, taxpayers purchased publicly traded foreign securities known as American Depository Receipts ("ADRs") at market prices immediately before the securities were to pay out dividends. Because the securities dividends were subject to a 15% foreign tax, they were priced at the market price plus 85% of the expected dividend. The taxpayer/buyer received 85% of the dividend and quickly resold the securities for market price back to the seller, sustaining a "loss" because the post-dividend market price of the securities was lower than the original purchase price. The taxpayer then claimed capital loss deductions in the United States, as well as foreign tax credits for the 15% foreign tax paid on the dividend. *See Compaq*, 277 F.3d at 779-80; *IES*, 253 F.3d at 352.

In analyzing the profitability of these transactions, both the *Compaq* and *IES* courts declined to consider the foreign taxes paid and foreign tax credits claimed in their economic substance analysis. Rather, the courts calculated profitability based on the gross dividend, before foreign taxes were paid. *Compaq*, 277 F.3d at 785; *IES*, 253 F.3d at 353-54. Accordingly, the Eighth Circuit awarded IES summary judgment on its tax refund claim because the ADR transactions did not lack economic substance or a business purpose as a matter of law. 253 F.3d at 356. The

Fifth Circuit in *Compaq* reversed the Tax Court below, holding that it erred in ignoring Compaq's pre-tax profit on the ADRs. 277 F.3d at 784.

The court in *Compaq* also faulted the Tax Court below for including foreign taxes paid but not foreign tax credits claimed in its calculation of pre-tax profit. "To be consistent, the analysis should either count all tax law effects or not count any of them. To count them only when they subtract from cash flow is to stack the deck against finding the transaction profitable." *Compaq*, 277 F.3d at 785; *see also IES*, 253 F.3d at 354.

The Tax Court in *BNY* acknowledged that its holding was inconsistent with *Compaq* and *IES* but noted that it was not bound by either decision. Emphasizing that neither the Supreme Court nor our Circuit had yet addressed the issue, the Tax Court considered the effect of foreign taxes in its objective economic substance analysis:

> Economically, foreign taxes are the same as any other transaction cost. And we cannot find any conclusive reason for treating them differently here, especially because substantially all of the foreign taxes giving rise to the foreign tax credits stemmed from economically meaningless activity, i.e., the pre-arranged circular cashflows engaged in by the trust.
>
> Additionally, excluding the economic effect of foreign taxes from the pre-tax analysis would fundamentally undermine the point of the

> economic substance inquiry. That point is to remove the challenged tax benefit and evaluate whether the relevant transaction makes economic sense.

140 T.C. at 35 n.9. Similarly, the Federal Circuit in *Salem*, decided after the Tax Court's decision in *BNY*, disagreed with the reasoning in *Compaq* and *IES*. The court in *Salem* concluded that the Tax Court's method of calculation reflects the core principles of the economic substance doctrine:

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

786 F.3d at 948. The court also emphasized that profit for purposes of "economic substance" must be analyzed within the context of the tax implications: "Even if there is some prospect of profit, that is not enough to give a transaction economic substance if the prospect of a non-tax return is grossly disproportionate to the tax benefits that are expected to flow from the transaction." *Id.* at 949.

We agree with the Tax Court in *BNY* and the Federal Circuit in *Salem*. The purpose of calculating pre-tax profit

in this context is not to perform mere financial accounting, subtracting costs from revenue on a spreadsheet: It is to discern, as a matter of law, whether a transaction meaningfully alters a taxpayer's economic position other than with respect to tax consequences. The motivation behind the economic substance inquiry "is to ensure that tax benefits are available only if '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.'" *Id.* (quoting *Frank Lyon*, 435 U.S. at 583-84). The doctrine was born out of necessity, as "[e]ven the smartest drafters of legislation and regulation cannot be expected to anticipate every [tax avoidance] device." *ASA Investerings P'ship v. Comm'r*, 201 F.3d 505, 513, 340 U.S. App. D.C. 55 (D.C. Cir. 2000). It is therefore appropriate for a court, when assessing the objective economic substance of a transaction, to include the foreign taxes paid but to exclude the foreign tax credits claimed in calculating pre-tax profit.

We are mindful, as was the district court in certifying the *AIG* case for interlocutory appeal, *Am. Int'l Grp., Inc. v. United States*, No. 09 Civ. 1871(LLS), 2013 U.S. Dist. LEXIS 184786, 2013 WL 7121184, at *3 (S.D.N.Y. Nov. 5, 2013), that some commentators have criticized this approach, accusing courts of blindly "buying into" the government's "smoke and mirrors" argument or "contorting" the economic substance doctrine "beyond

any recognizable bounds."[9] Including foreign taxes in calculating pre-tax profit is inappropriate, they argue, because the transactions are motivated by foreign tax benefits to foreign lenders, not by U.S. tax benefits for U.S. borrowers. Further, they contend, this method of calculation "fictionalizes" the transactions, including the costs of the transactions but not the corresponding income.

We find these arguments unpersuasive. The purpose of the foreign tax credit is to facilitate global commerce by making the IRS indifferent as to whether a business transaction occurs in this country or in another, not to facilitate international tax arbitrage. The transactions in both *AIG* and *BNY* were structured to benefit foreign lenders but they were *also* structured to benefit U.S. borrowers. Indeed, in *BNY*, Barclays paid the tax-spread to BNY to share the U.K. tax benefits of STARS between the parties at the same time that BNY sought a foreign tax credit in an amount greater than that which -- after payment of the tax-spread -- it was actually out of pocket. In both cases, funds were treated as a "loan" for U.S. tax purposes but as equity for foreign tax purposes solely to

9. *See* Kevin Dolan, *The Foreign Tax Credit Diaries -- Litigation Run Amok*, 71 Tax Notes Int'l 831, 833-34, 836 (2013); Richard M. Lipton, BNY & AIG -- *Using Economic Substance to Attack Transactions the Courts Do Not Like*, 119 J. Tax 40, 46 (2013); Jason Yen & Patrick Sigmon, *District Court's* "AIG" *Ruling Expands Application of Economic Substance Doctrine in Unexpected Ways for Transactions Generating Excess Foreign Tax Credits*, Daily Tax Rep., May 2, 2013. *But see* Michael S. Knoll, Compaq *Redux: Implicit Taxes and the Question of Pre-Tax Profit*, 26 Va. Tax Rev. 821 (2007).

minimize tax in both countries. Hence, the transactions themselves "fictionalize" the concept of international trade. In *BNY*, for example, funds contributed to a U.S. trust that never left the United States were nonetheless subjected to U.K. taxation because BNY installed a nominal U.K. trustee. Further, the trust distributions were briefly transferred to a Barclays blocked account, then immediately transferred back to the trust simply to trigger certain tax consequences. Similarly, in AIG, the SPVs had no real employees or business purpose of their own beyond creating tax benefits for the both the lender and borrower.

While the transactions are certainly "real" insofar as real money changed hands, they are most appropriately characterized as "shams" under the economic substance doctrine, taken to avoid taxes. As discussed in more detail below, the trust transaction in *BNY* had little to no potential for economic return apart from the tax benefits. And when the record in *AIG* is viewed most favorably to the government, a reasonable factfinder could reach the same conclusion as to the cross-border transactions. Accordingly, we hold that foreign taxes are economic costs for purposes of the economic substance doctrine and thus should be deducted from profit *before* calculating pre-tax profit.

The objective economic substance inquiry, however, does not end at profit, as a legitimate transaction could conceivably lack economic profit. *See Salem*, 786 F.3d at 950 ("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." (citing *Sacks v. Comm'r*, 69 F.3d 982, 990-92 (9th Cir.1995))). The Supreme Court has indeed cautioned: "There is no simple device available to peel away the form of [a] transaction and to reveal its substance." *Frank Lyon*, 435 U.S. at 576. A court should also look to the overall economic effect of the transaction in determining objective economic substance. In conducting this inquiry, we agree with the Tax Court that "[e]conomic benefits that would result independent of a transaction do not constitute a non-tax benefit for purposes of testing its economic substance." *Bank of N.Y. Mellon*, 140 T.C. at 36-37. Determining whether a given transaction has economic substance under the objective prong therefore requires *both* a calculation of pre-tax profit and a consideration of the transaction's overall economic effect. Accordingly, the overall determination of objective economic substance is a question of fact.

b. *Subjective Economic Substance*

Apart from the objective inquiry, a court must also look to the subjective business purpose of a transaction to determine whether it has economic substance. Under the subjective inquiry, a court asks whether the taxpayer has a legitimate, non-tax business purpose for entering into the transaction. *See id.* at 37; *Long Term Capital Holdings*, 330 F. Supp. 2d at 186. "The business purpose inquiry 'concerns the motives of the taxpayer in entering the transaction;' it asks whether the taxpayer's 'sole

motivation' for entering a transaction was to realize tax benefits." *Altria*, 694 F. Supp. 2d at 281 (quoting *Rice's Toyota World, Inc. v. Comm'r*, 752 F.2d 89, 92 (4th Cir. 1985)). The focus is the reasonableness of the transaction and can be articulated as: would "a prudent investor," absent tax benefits, "have made the deal?" *See Long Term Capital Holdings*, 330 F. Supp. 2d at 186. This inquiry is, by nature, factual.

2. *Application*

a. AIG

AIG argues that, as a matter of law, even if the economic substance doctrine applies generally to foreign tax credits, the cross-border transactions had economic substance. To support this argument, AIG points to its calculated $168.8 million in pre-tax profit, a calculation that ignores the foreign taxes paid by the SPV, the U.S. tax paid by AIG on the SPV's investment income, and the foreign tax credits claimed by AIG. The district court acknowledged that "[i]f the computation of that figure proves correct, AIG would be entitled to judgment," but ultimately rejected AIG's method and accordingly found that AIG was not entitled to partial summary judgment. *Am. Int'l Grp.*, 2013 U.S. Dist. LEXIS 45871, 2013 WL 1286193, at *5.

We agree that there are disputed issues of material fact as to both the objective and subjective economic substance of the cross-border transactions. The district court therefore properly denied AIG's motion for partial

summary judgment. There is sufficient evidence in the record from which a reasonable factfinder could conclude, as the government contends, that the transactions lacked economic substance.

Under the objective prong, there are unresolved material questions of fact regarding the overall economic effect of the cross-border transactions and the reasonableness of AIG's expectation of non-tax benefits -- indeed, expert discovery has not yet commenced in this case. The government's economist, Dr. Michael Cragg, has done preliminary analysis of the transactions, and for the purposes of its summary judgment motion, AIG did not contest his calculations. 2013 U.S. Dist. LEXIS 45871, [WL] at *6. According to Dr. Cragg, "[a]side from the tax benefits, the transactions involved little, if any, potential for economic return," as "absent the claimed tax benefits, the transactions neither generated material economic returns for AIG, nor offered the potential for such returns, after accounting for dividend payments, operating expenses, and foreign taxes." AIG App. at 2353, 2360. Dr. Cragg thus concluded that the "transaction structure inflated the foreign tax liabilities of the SPVs and generated income from tax benefits for AIG at the direct expense of the United States." *Id.* at 2356. Further, the SPVs had no substantive business activities of their own and absent capital contributions from AIG, they would not have had sufficient cash flow to cover their expenses or pay out dividends. Overall, the value of the foreign tax credits produced far exceeded any independent potential for economic return from the cross-border transactions. Insofar as AIG contends that,

in considering the transaction's profitability, the district court inappropriately deducted the foreign taxes paid by the SPV, we reject that argument in light of our holding that, as a matter of law, foreign taxes are properly deducted in assessing a transaction's pre-tax profitability. Accordingly, a reasonable factfinder could conclude that the transactions lacked objective economic substance.

Under the subjective prong, there are also material questions of fact regarding AIG's business purpose for entering the cross-border transactions. As the government highlights, AIG's own internal documents described the cross-border transactions as "tax driven" and "tax based deal[s]." *Id.* at 2315, 2317. Similarly, a foreign purchaser of a cross-border transaction acknowledged "[t]he benefit to AIG comes from US tax laws whereby they can obtain a credit for the tax paid in [the foreign country] and a deduction for the . . . dividend paid. The tax credit effectively reduces their cost of borrowing . . . ." *Id.* at 2319. Further, AIG-FP retained the right to terminate the transactions due to "changes in tax law" or if AIG could not "soak up the excess foreign tax credits." *Id.* at 2320. Accordingly, a reasonable factfinder could conclude that AIG lacked a legitimate, non-tax business purpose in entering the transactions.

Thus, viewing the evidence in the light most favorable to the government, as the non-moving party, we hold that the government offered sufficient evidence to permit a reasonable factfinder to find in its favor. Hence, the district court did not err in denying partial summary judgment. *See, e.g., Black & Decker Corp. v. United States*, 436 F.3d

431, 442 (4th Cir. 2006) (reversing summary judgment to taxpayer where IRS presented evidence from experts showing transaction at issue lacked economic substance).

b. BNY

Like AIG, BNY argues that as a matter of law, STARS had economic substance. BNY points to the $1.5 billion loan from Barclays as proof of economic substance, and maintains that although tax benefits were part of its motivation for entering STARS, this does not negate the transaction's economic substance. BNY contends that the Tax Court erred in calculating pre-tax profit by: 1) bifurcating its analysis of the trust transaction and the $1.5 billion loan and, as a result, excluding the amount BNY expected to earn by investing the loan proceeds; 2) counting the foreign taxes paid as a cost; and 3) disregarding the tax-spread.

We conclude that the Tax Court committed no error. First, the Tax Court appropriately bifurcated its analysis of the STARS trust transaction from the $1.5 billion loan. As we have held, "[t]he relevant inquiry is whether the transaction that generated the claimed deductions . . . had economic substance." *Nicole Rose*, 320 F.3d at 284. We agree with the Tax Court that "the requirements of the economic substance doctrine are not avoided simply by coupling a routine transaction with a transaction lacking economic substance." *Bank of N.Y. Mellon*, 140 T.C. at 34; *see Long Term Capital Holdings*, 330 F. Supp. 2d at 183

(quoting *Nicole Rose*).[10] In BNY's case, the disputed tax benefits for the trust transaction and the loan are distinct: foreign tax credits versus interest expense deductions. We thus cannot say that the Tax Court erred in analyzing the transactions separately.

Second, the Tax Court did not err in its calculation of the trust transaction's objective economic substance. Because it considered the trust transaction separately from the loan, the Tax Court properly excluded the amount that BNY expected to earn by investing the loan proceeds from its calculation of the trust transaction's profit. Further, in light of our holding that, as a matter of law, foreign taxes should be deducted when calculating pre-tax profit, the Tax Court did not err in considering foreign taxes paid by BNY on behalf of the trust and in concluding that the trust did not offer a reasonable opportunity for economic profit because, as demonstrated in the hypothetical above, for every $100 in trust income, BNY incurred a $22 loss by paying foreign taxes.

Finally, in considering the overall economic effect of the transaction, the Tax Court did not err in excluding the tax-spread that Barclays paid BNY from calculated profit.

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10. Congress, when codifying the economic substance doctrine, further supported this interpretation by noting that under present law, courts could "bifurcate a transaction in which independent activities with non-tax objectives are combined with an unrelated item having only tax-avoidance objectives in order to disallow those tax-motivated benefits." Staff of J. Comm. on Taxation, 111th Cong., Technical Explanation of the Revenue Provisions of the "Reconciliation Act of 2010," as Amended, in Combination with the "Patient Protection and Affordable Care Act," 153 & n.352 (J. Comm. Print 2010).

The Tax Court found that the tax-spread was a "tax effect . . . . serv[ing] as a device for monetizing and transferring the value of anticipated foreign tax credits generated from routing income through the STARS structure." *Bank of N.Y. Mellon*, 140 T.C. at 43. BNY itself referred to the tax-spread as a "rebate from Barclays" which Barclays paid to share the tax benefits of STARS with BNY. BNY App. at 1525. Moreover, as BNY concedes, the parties agreed that the tax-spread would be half of the pre-tax value of Barclays' expected U.K. tax benefits, which amounted to $11 for every $100 of trust income. Thus, even offsetting BNY's foreign tax payment of $22 with the tax-spread, BNY still lost $11 for every $100 of trust income. The Tax Court therefore reasonably concluded that "regardless of how the spread is characterized, the benefit of the spread was more than offset by the additional transaction costs that BNY incurred to obtain the spread." *Bank of N.Y. Mellon*, 140 T.C. at 43 n.15.

As noted above, the objective economic substance analysis does not end at profit, and the Tax Court here appropriately considered other aspects of the trust transaction to assess economic substance. Notably, the Tax Court found that the transaction's circular cash flow strongly indicated that its main purpose was to generate tax benefits for BNY and Barclays. *See Altria*, 658 F.3d at 289; *see also Salem*, 786 F.3d at 950 (affirming trial court's conclusion that STARS transaction "lacked economic reality" in part because the transaction "consisted of 'three principal circular cash flows,' which, apart from their intended tax consequences, had no real economic effect.").

Indeed, this circular cash flow demonstrates that BNY, far from risking double taxation, used an extremely convoluted transaction structure to take maximum advantage of U.S. and U.K. tax benefits. BNY was reimbursed for half of its U.K. tax payments and simultaneously claimed a foreign tax credit in the United States for the full payment amounts. Toward this end, BNY created a trust in the United States whose funds never left the United States; yet BNY installed a nominal U.K. trustee precisely so the trust would be subject to U.K. taxation. The trust's distribution structure makes little sense except in light of the tax implications: each month funds were briefly sent to a blocked Barclays account then immediately returned to the trust. The purpose of this two-step process was to allow Barclays to claim a U.K. tax loss while BNY could claim a U.S. foreign tax credit. Because this structure allowed Barclays to recover the cost of U.K. taxes paid by BNY, Barclays shared the tax benefits with BNY by paying BNY the tax-spread.

Third, the Tax Court did not err in finding that STARS lacked a subjective business purpose beyond tax avoidance. The Tax Court found that the STARS structure lacked a reasonable relationship to BNY's claimed business purposes and BNY's interest in STARS was entirely predicated on the tax benefits it involved. *Bank of N.Y. Mellon*, 140 T.C. at 38-40. BNY asserted that the business purpose for entering into the STARS transaction was to obtain a low-cost loan from Barclays. *Id.* at 40. The loan, however, was only "low-cost" if the tax-spread was considered a component of the loan interest. The Tax Court reasonably concluded that the tax-spread should

not be so considered because, although the tax-spread was netted against the interest BNY owed on the loan, there was no real relationship between the two. *Id.* at 42. Rather, the tax-spread was a way for Barclays to share half of the pre-tax value of its expected U.K. tax benefits with BNY, and thus allow BNY to obtain $2 of foreign tax credit for each $1 of expenditure. *Bank of N.Y. Mellon*, 140 T.C. at 41-43. Absent this sharing of tax benefits, BNY's loan -- with a monthly interest of one-month LIBOR plus 30 basis points -- was not "low cost" because BNY could otherwise have borrowed money at or below LIBOR. Further support for the Tax Court's determination that BNY's singular motivation was the two-for-one tax benefit is evident in BNY's global tax director's acknowledgment that KPMG "knew that if I wasn't comfortable with our overall tax position and our ability to use those [foreign tax] credits, then the transaction wouldn't get off the ground." BNY App. at 363.

Accordingly, considering the objective and subjective prongs of our Circuit's flexible economic substance test together, we hold that the Tax Court correctly concluded that the STARS trust transaction lacked economic substance.

C. Deductibility of Interest Expenses

1. *Applicable Law*

The Code permits the deduction of "all interest paid or accrued within the taxable year on indebtedness." 26 U.S.C. § 163(a). Thus, a taxpayer is ordinarily entitled

to deduct interest paid on indebtedness, reducing its taxable income for a given year. *See Lee v. Comm'r*, 155 F.3d 584, 586 (2d Cir. 1998). "Interest payments are not deductible[, however,] if they arise from transactions that can not with reason be said to have purpose, substance, or utility apart from their anticipated tax consequences. Such transactions are said to lack economic substance." *Id.* (citation omitted) (internal quotation marks omitted). We have repeatedly held that an interest deduction is not allowed if the interest payment arises from a transaction that is economically empty, e.g., a loan whose sole purpose is to generate interest deductions. *See id.*; *Goldstein*, 364 F.2d at 740.

The Federal Circuit in *Salem* -- again analyzing a STARS transaction under a bifurcated analysis -- held that, unlike *Lee* and *Goldstein*, "there is no evidence that [the taxpayer bank] designed the Loan solely to claim the interest deductions." 786 F.3d at 957. "While it may be true that the Loan operated partly to camouflage the [tax-spread] payment, it also resulted in a substantive change in [the taxpayer bank's] economic position. As a result of the Loan transaction, [the taxpayer bank] obtained unrestricted access to $1.5 billion in loan proceeds." *Id.*

2. Application

The Commissioner contends that BNY's loan lacked economic substance because it was overpriced and motivated by tax avoidance, and that therefore BNY should not be able to deduct associated interest expenses. *See Kerman v. Comm'r*, 713 F.3d 849, 865 (6th Cir. 2013) (concluding that loan transaction lacked economic substance, in part because of its "absurdly high interest

rate" (internal quotation marks omitted)). We agree with the Tax Court that the $1.5 billion loan from Barclays had independent economic substance. Thus, BNY was entitled to deduct the interest expenses it paid on this loan.

First, as discussed above, the Tax Court correctly bifurcated the STARS trust transaction from the $1.5 billion loan.

Second, we conclude that the $1.5 billion loan had independent economic substance. In *Lee* and *Goldstein*, we held that interest expenses were not deductible because the relevant loan arrangements could "not with reason be said to have purpose, substance, or utility apart from their anticipated tax consequences." *Goldstein*, 364 F.2d at 740; *see Lee*, 155 F.3d at 586-87. As the Tax Court observed, however, BNY "did not use the loan proceeds to finance, secure or carry out the STARS structure. The loan was not necessary for the STARS structure to produce the disallowed foreign tax credits. Rather, the loan proceeds were available for petitioner to use in its banking business throughout the STARS transaction." *Bank of N.Y. Mellon Corp. v. Comm'r*, T.C. Memo 2013-225, 106 T.C.M. (CCH) 367 (T.C. 2013). Under both the objective and subjective prongs of the economic substance doctrine, the loan was no sham: It constituted $1.5 billion in cash that was available for BNY to utilize in any way it saw fit throughout the duration of STARS.

The Commissioner argues that because the loan was "overpriced" -- as BNY could have obtained a similar loan at a lower cost in the marketplace -- we should still disallow

the interest expense deductions. We have held, however, that "[e]ven if the motive for a transaction is to avoid taxes, interest incurred therein may still be deductible if it relates to economically substantive indebtedness." *Lee*, 155 F.3d at 586 (quoting *Jacobson*, 915 F.2d at 840) (internal quotation marks omitted). Again, here, the $1.5 billion loan was economically substantive. We thus decline to disallow the deductions on the theory that BNY's loan lacked economic substance because it was overpriced.

Accordingly, we conclude that the Tax Court did not err, on reconsideration, in allowing BNY to deduct interest expenses on the $1.5 billion loan.

CONCLUSION

Accordingly, the decisions of the district court and Tax Court are AFFIRMED. To summarize:

(1) We reject AIG's contention that foreign tax credits, by their nature, are not reviewable for economic substance. The purpose of the "economic substance" doctrine is to ensure that a taxpayer's use of a tax benefit complies with Congress's purpose in creating that benefit. Accordingly, we hold that the "economic substance" doctrine can be applied to disallow a claim for foreign tax credits.

(2) In determining whether a transaction lacks economic substance, we consider: (a) whether the taxpayer had an objectively reasonable expectation of profit, apart from tax benefits, from the transaction; and (b) whether the taxpayer had a subjective non-tax business purpose

in entering the transaction. *Gilman*, 933 F.2d at 147-48. In our Circuit, we employ a "flexible" analysis where both prongs are factors to consider in the overall inquiry into a transaction's economic substance.

(3) The focus of the objective inquiry is whether the transaction "offers a reasonable opportunity for economic profit, that is, profit exclusive of tax benefits." *Gilman*, 933 F.2d at 146 (internal quotation marks omitted). We conclude, as a matter of first impression in this Circuit, that foreign taxes are economic costs and should thus be deducted when calculating pre-tax profit. We also conclude that it is appropriate, in calculating pre-tax profit, for a court both to include the foreign taxes paid and to exclude the foreign tax credits claimed. In so holding, we agree with the Federal Circuit in *Salem* and disagree with decisions of the Fifth and Eighth Circuits (*Compaq* and *IES*, respectively).

(4) Under the subjective prong, a court asks whether the taxpayer has a legitimate, non-tax business purpose for entering into the transaction.

(5) As to AIG's transactions, we hold that there are unresolved material questions of fact regarding the *objective* factors -- i.e., the economic effects of the cross-border transactions and the reasonableness of AIG's expectation of non-tax benefits. There are also material questions of fact regarding AIG's *subjective* business purpose for entering the cross-border transactions. Because a reasonable factfinder could resolve these questions in favor of the government and conclude

therefrom that the cross-border transactions lacked economic substance, the district court did not err in denying AIG's motion for partial summary judgment.

(6) As to BNY's transactions, we hold that the Tax Court correctly concluded that the STARS trust transaction lacked economic substance. We also hold that the Tax Court did not err in concluding that the $1.5 billion loan from Barclays had independent economic substance, and that BNY was therefore entitled to deduct the associated interest expenses. Accordingly, we affirm the Tax Court's judgment in its entirety.

APPENDIX C — ERRATA OF THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT, DATED SEPTEMBER 23, 2015

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

August Term 2014

(Argued: May 18, 2015 Decided: September 9, 2015)

Docket Nos. 14-704-ag(L), 14-1394-ag(XAP), 14-765-cv

THE BANK OF NEW YORK MELLON CORPORATION, as Successor in Interest to THE BANK OF NEW YORK COMPANY, INC.,

Petitioner-Appellant-Cross-Appellee,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee-Cross -Appellant.

AMERICAN INTERNATIONAL GROUP, INC.,

Plaintiff-Appellant,

v.

UNITED STATES OF AMERICA,

Defendant-Appellee.

Appendix C

ERRATA

Page (of slip on.)	Line	Delete	Insert
44	1-2	the Tax Court properly excluded the loan proceeds BNY expected to earn	the Tax Court properly excluded the amount BNY expected to learn
44	11	the district court	the Tax Court

Copies have been sent by chambers to:

x Panel Members
_ West Publishing Co.
x Clerk of Court

So Ordered:

s/_____ **9-23-2015**
Denny Chin, Circuit Judge **Date**

APPENDIX D — OPINION AND ORDER OF THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK, DATED MARCH 29, 2013

UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

09 Civ. 1871 (LLS)

AMERICAN INTERNATIONAL GROUP, INC.,
and its subsidiaries,

Plaintiff,

- against –

UNITED STATES OF AMERICA,

Defendant.

OPINION AND ORDER

Plaintiff American International Group, Inc., ("AIG") renews its July 30, 2010 motion for partial summary judgment that it is entitled to credits for foreign taxes paid by affiliates ("Special Purpose Vehicles" or "SPVs") it used to effect six transactions between AIG Financial Products Corp. ("AIG-FP," a wholly-owned subsidiary of AIG) and certain overseas financial institutions.[1] The

1. In a March 29, 2011 Memorandum Endorsement (Dkt. No. 85) and in response to the Government's request for additional discovery, I denied AIG's earlier motion "without prejudice

Internal Revenue Service ("IRS") disallowed the credits on AIG's 1997 tax return and claimed additional amounts due in taxes, interest and penalties in a March 20, 2008 notice of deficiency. AIG paid those amounts and now seeks an appropriate refund.

The Government claims the disallowance was proper because the transactions lack economic substance. For the reasons which follow, the motion is denied.

BACKGROUND

From 1993 to 1997, AIG-FP entered into six transactions[2] structured to take "advantage of the

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and with leave to renew, on these or other papers, following the completion of discovery concerning the domestic transactions," i.e., a series of transactions AIG claimed to be the same, in all material respects, to the six at issue on this motion but for their use of domestic rather than foreign affiliates of AIG. It eventually became clear that resolution of the disputes concerning the domestic transactions would not provide a ground for decision of this motion and would necessitate a complete analysis and ruling on the appropriate tax treatment of the domestic transactions. Thus, with the consent of AIG and over an objection by the Government, I directed the parties to limit their discussion in the renewed motion papers to the foreign transactions only. See Tr. of July 20, 2012 Conf. (Dkt. No. 112).

2. The names and dates of, and counterparties to, the disputed transactions are as follows:

"Laperouse," entered on or about September 30, 1993 with Credit Agricole.

"Vespucci," on or about December 18, 1995 with Banca Commerciale Italiana.

mismatch between U.S." and foreign tax law governing agreements to sell and repurchase preferred stock. Reply at 7. AIG describes the transactions as loans; the Government as foreign tax credit generators. Both agree that each proceeded as follows, with variations in structure immaterial, for resolution of this motion.

In each transaction, AIG-FP sold a foreign lender bank preferred shares in a foreign AIG-FP affiliate (the "Special Purpose Vehicle" or "SPV") and committed to repurchase those shares after a term of years for the original price paid by the lender bank.

Capitalized primarily from the sale of shares, the SPV purchased investments which generated a steady income. It paid taxes on the investment income to its overseas tax authority and distributed much of the net proceeds to the lender.

The lender paid little, if any, tax on the distribution ("dividend"). Its tax authority considered the lender's purchase of preferred stock to be an equity investment in the SPV, despite AIG-FP's obligation to repurchase the shares, and therefore treated the SPV as the lender's

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"NZ Issuer" or "New Zealand," December 11-19, 1996, with Bank of New Zealand.

"Maitengrove," on or about February 28, 1997, with Bank of Ireland.

"Lumagrove," on or about August 27, 1997, with Bank of Ireland.

"Palmgrove," on or about October 20, 1997, with Irish Permanent.

corporate subsidiary, and the dividend as a tax-exempt distribution from subsidiary to parent.

On its 1997 U.S. tax return, AIG claimed foreign tax credits for the full amount of foreign tax paid by the SPV, which exceeded AIG's U.S. tax owed on the transactions, allowing it to apply portions of the credits to its tax liability on income from other transactions. AIG claims that under U.S. tax law, the lender's purchase of preferred stock was a loan to the SPV, and the SPV remained AIG's corporate subsidiary, because of the repurchase obligation. Thus, AIG reported all of the SPV's investment income, but deducted as an interest expense the dividend paid to the lender. The table below summarizes the U.S. tax reported on AIG's 1997 return as a result of the transactions.

Appendix D

Tax Reported on These Transactions on AIG's 1997 U.S. Tax Return (in U.S. Dollars)[3]

	Total Gross Income	Interest Expense	Net Taxable Income	Tax Owed	Foreign Tax Credit
Laperouse	42,646,064	23,165,617	19,480,447	6,818,156	17,769,336
Vespucci	15,798,043	8,509,043	7,289,000	2,551,150	6,582,571
NZ Issuer	43,268,472	24,701,584	18,566,888	6,498,411	4,278,596
Maitengrove	13,205,250	7,767,892	5,437,358	1,903,075	4,784,663
Lumagrove	10,641,511	6,125,265	4,516,246	1,580,686	3,830,944
Palmgrove	2,626,417	1,601,925	1,024,492	358,572	945,510
Total	128,185,757	71,871,326	56,314,431	19,710,050	48,191,620

3. All figures, except those appearing in column 4 ("Tax Owed"), are drawn from Figure 1 of AIG's 2010 Reply brief, at page 12. The numbers in column 4 are 35% of the corresponding Net Taxable Income amounts appearing in column 3, and are based on AIG's statement that it "was required to and did - pay U.S. tax on that taxable income at the standard U.S. corporate income tax rate, which was 35%." *Id.*

Thus, as a result of those tax effects, the parties' combined tax burden on the investment income was minimal. The foreign tax credits claimed by AIG offset the foreign tax obligations of the SPV; the lender's dividend was tax-exempt; and AIG paid U.S. taxes on only a portion of the investment income, having deducted much of it as an interest expense.

AIG contends the transactions were merely instances of highly profitable spread banking activity: AIG-FP borrowed funds from each lender, purchased investments, used the return on the investments to pay the lender a suitable interest, and profited from the difference between the interest and the return on the investments.

The Government claims tax benefits generated that spread profit. According to the Government, AIG and the lender "effectively shifted" tax liability "from the foreign bank to the SPV," Opp. at 5, which allowed the lender to receive its return as a tax-exempt dividend, and AIG to claim foreign tax credits and interest deductions to offset much of the foreign tax paid by the SPV. Those tax savings permitted AIG to negotiate a dividend rate lower than the return on the investments, creating AIG's profitable spread. *Id.*

Thus, the Government argues the transactions lack economic substance, i.e., they "can not with reason be said to have purpose, substance, or utility apart from their anticipated tax consequences," *Lee v. Comm'r*, 155 F.3d 584, 586 (2d Cir. 1998) (quotation marks omitted). AIG claims the economic substance doctrine does not

apply, and that the transactions have economic substance because they were expected to generate a pre-tax profit over the life of the transactions of "at least $168.8 million." Reply at 12.

DISCUSSION

Under Federal Rule of Civil Procedure 56(a), "the court shall grant summary judgment if the movant shows that there is no genuine dispute as to any material fact and the movant is entitled to judgment as a matter of law." "This standard requires that courts resolve all ambiguities, and credit all factual inferences that could rationally be drawn, in favor of the party opposing summary judgment." *Spinelli v. City of New York*, 579 F.3d 160, 166 (2d Cir. 2009) (internal quotation marks omitted).

"Any 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." *Helvering v. Gregory*, 69 F.2d 809, 810 (2d Cir. 1934), *aff'd*, *Gregory v. Helvering*, 293 U.S. 465, 55 S. Ct. 266, 79 L. Ed. 596 (1935) ("The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted."). "However, even if a transaction's form matches 'the dictionary definitions of each term used in the statutory definition' of the tax provision, 'it does not follow that Congress meant to cover such a transaction' and allow it a tax benefit." *Altria Group, Inc. v. United*

States, 658 F.3d 276, 284 (2d Cir. 2011), quoting *Helvering*, 69 F.2d at 810. Thus, "the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended." *Gregory*, 293 U.S. at 469, 55 S. Ct. at 267.

1.

The parties dispute how to determine whether what was done, apart from the tax motive, was what Congress intended when it established the foreign tax credit.

The Government argues AIG must prove the transactions had economic substance, because Congress did not intend to confer foreign tax credits to transactions which lack economic substance. *See Ferguson v. Comm'r*, 29 F.3d 98, 101 (2d Cir. 1994) ("An activity will not provide the basis for deductions if it lacks economic substance."), citing *Gregory*, 293 U.S. at 469, 55 S. Ct at 267.

AIG argues proof of economic substance is immaterial because "The purpose of the statute involved in this case is to eliminate double taxation, and there is no dispute that disallowance of the credits at issue would subject AIG to double taxation." Reply at 10.

As AIG states, "the economic substance doctrine does not apply in every context - it only applies when the requirements that it would impose can fairly be derived from the terms and purpose of the statute that is at issue." *Id.* (emphasis omitted). "The opinion in *Gregory v. Helvering* permits proper tax avoidance," and "as

to many transactions Congress has clearly intended tax relief irrespective of the parties' motives," *Diggs v. Comm'r*, 281 F.2d 326, 329, or has "purposely skewed the neutrality of the system" to induce activity which would otherwise result in an economic loss, *Sacks v. Comm'r*, 69 F.3d 982, 991 (9th Cir. 1995). To require, as the economic substance doctrine does, a taxpayer to prove a "business purpose" and "reasonable possibility of profit" "apart from tax benefits," *Nicole Rose Corp. v. Comm'r*, 320 F.3d 282, 284, 52 Fed. Appx. 545 (2d Cir. 2003), would subvert the purpose of Congress with respect to such transactions.

But those requirements are consonant with the purpose of the foreign tax credit, because Congress intended the credit to facilitate purposive business transactions, not by subsidy, but by restoring the neutrality of the tax system.

The United States taxes the income of its citizens and residents regardless of where the income is earned. Income earned abroad is often also subject to foreign tax. Congress passed the foreign tax credit to mitigate such double taxation of foreign income by permitting the taxpayer to subtract the amount he pays or accrues in foreign tax from his U.S. tax bill. *See, e.g.*, *Kraft Gen. Foods v. Iowa Dep't of Rev. & Fin.*, 505 U.S. 71, 73, 112 S. Ct. 2365, 2367, 120 L. Ed. 2d 59 (1992). Thus, the credit "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," H.R. Rep. No. 83-1337 at 76 (1954), i.e., to "neutralize the effect of U.S. tax on the business decision of where to conduct business

activities most productively," *Bank of New York Mellon Corp. v. Comm'r*, 26683-09, 140 T.C. 15, 2013 U.S. Tax Ct. LEXIS 2, 2013 WL 499873, at *18 (U.S. Tax Ct. Feb. 11, 2013).

Motivating Congress to relieve the "very severe burden," H.R. Rep. No. 65-767, at 11 (1918), on foreign income was the need to facilitate "the extension by domestic corporations of their business abroad," *Burnet v. Chicago Portrait Co.*, 285 U.S. 1, 7-10, 52 S. Ct. 275, 277-78, 76 L. Ed. 587, 1932 C.B. 286, 1932-1 C.B. 286 (1932), and to "encourage American foreign trade," *Comm'r v. Am. Metal Co.*, 221 F.2d 134, 137 (2d Cir. 1955). As stated during debate of the Revenue Act of 1918, which first established the credit:

> Suppose we had a meat company over in Montreal and they would send to St. Louis a Canadian citizen from Montreal and pay him $50,000 a year; this Government would tax him on $50,000, although he would be a British subject - a Canadian citizen. Canada would tax him, also. Canada, no doubt, will do as we are doing by this bill - pass a law that will permit its citizen earning an income here to deduct from his tax levied by her the amount of tax paid by him to the United States. That is not only a just provision, but a very wise one. It is wise from the standpoint of the commerce of the United States, of the expansion of business of the United States. There are thousands of citizens of the United States now going to South

> America, and they have been going for years, and we have thousands of citizens in Canada. We would discourage men from going out after commerce and business in different countries or residing for such purposes in different countries if we maintained this double taxation. They would take their corporations that are American corporations and reorganize them, getting their charters in such foreign countries, if we did not do this, and we might not be able to tax their income and profits at all. Another thing: If we did not do that, a man would become a citizen of another country instead of retaining his citizenship here in order to escape the large and double taxation imposed.

56 Cong. Rec. App. 677 (1918) (statement of Rep. Kitchin).

Because Congress created the foreign tax credit for the taxpayer "who desires to engage in purposive activity," *Goldstein v. Comm'r*, 364 F.2d 734, 742 (2d Cir. 1966), and sought only to eliminate the disadvantage to his foreign business imposed by U.S. taxation of worldwide income, it appears not to have intended the credit be available to transactions "that have no economic utility and that would not be engaged in but for the system of taxes imposed by Congress" simply because the transactions caused the taxpayer to pay foreign tax. *Id.* at 741.

Thus, in its claim to avoid double taxation, AIG cannot exclude consideration of the transactions' "economic utility" and must show that "what was done, apart from

the tax benefits, is what was intended" by Congress. *See Compaq Computer Corp. v. Comm'r*, 277 F.3d 778 (5th Cir. 2001) (applying economic substance doctrine to claim for foreign tax credits); *IES Indus. v. United States*, 253 F.3d 350 (8th Cir. 2001) (same); *Pritired 1, LLC v. United States*, 816 F. Supp. 2d 693 (S.D. Iowa 2011) (same); *Bank of New York*, 2013 U.S. Tax Ct. LEXIS 2, 2013 WL 499873, at *16-19 (U.S. Tax Ct. Feb. 11, 2013) (same).

2.

Under the economic substance doctrine, tax benefits will be disallowed if a transaction "has no business purpose or economic effect other than the creation of tax" benefits. *Nicole Rose*, 320 F.3d at 284.

"The business purpose inquiry 'concerns the motives of the taxpayer in entering the transaction.'" *Altria Group, Inc. v. United States*, 694 F. Supp. 2d 259, 283 (S.D.N.Y. 2010) (quoting *Rice's Toyota World, Inc. v. Comm'r*, 752 F.2d 89, 92 (4th Cir. 1985)), *aff'd*, 658 F.3d 276, 281 (2d Cir. 2011).

"The economic effect inquiry requires an objective determination of whether a reasonable possibility of profit from the transaction existed apart from tax benefits," *id.* at 283 (internal quotation marks omitted); see *Gilman v. Comm'r*, 933 F.2d 143, 148 (2d Cir. 1991).

AIG claims the transactions' purpose and effect was the $168.8 million pre-tax profit they were expected to obtain through spread banking. If the computation of that

figure proves correct, AIG would be entitled to judgment, because "a transaction has economic substance and will be recognized for tax purposes" if it was expected to result in a significant pre-tax profit, *Gilman*, 933 F.2d at 147, as "greater weight is given to objective facts than to the taxpayer's mere statement of intent," *Lee*, 155 F.3d at 586.

Thus, the function of the economic substance doctrine is to distinguish the transaction "which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance," *Frank Lyon Co. v. U.S.*, 435 U.S. 561, 583-84, 98 S. Ct. 1291, 1303, 55 L. Ed. 2d 550 (1978), from the transaction which "can not with reason be said to have purpose, substance, or utility apart from its anticipated tax consequences," *United States v. Coplan*, 703 F.3d 46, 91 (2d Cir. 2012), or, in this case, to determine whether AIG merely sought to minimize its tax burden on otherwise profitable spread banking activity, or whether the spread between AIG's cost of borrowing and its return on investment existed only because of the transactions' tax consequences, including its negotiated division of its inherent tax benefits.

To arrive at its $168.8 million figure, AIG modifies the computation of its expected return on the borrowed funds, as performed by the Government's expert Dr. Michael Cragg,[4] by adding toward AIG's profit the foreign tax

4. The borrowed funds are the funds AIG-FP received from the lender in exchange for its preferred stock in the SPV. Those funds provided much of the SPV's capital; the rest was provided by AIG's own contribution. AIG asserts that its pre-tax profit would

paid by the SPV. As a result, AIG's figure takes the SPV's investment income, subtracts its obligations to the lender and its operating expenses, and disregards the following: the foreign tax paid by the SPV on its investment income, the U.S. income tax paid by AIG on the SPV's investment income, and the value of the foreign tax credits to which AIG claims it is eligible.

AIG's calculation does not, however, exclude the effects of the tax-exempt status of the lender's dividend. Because (until AIG-FP repurchased the shares) the lender bank was considered the parent of the SPV, the SPV's transfer of funds to the bank was tax-exempt (see p. 3 above). The lender bank shared this benefit with AIG-FP by giving AIG-FP a more favorable dividend rate. As Mauro Gabriele, then-chief executive of AIG affiliate Banque AIG testified regarding Vespucci (involving foreign lender BCI) and Laperouse (involving foreign lender Credit Agricole):

> Q: Fair enough. So to what extent did the fact that BCI was receiving a dividend tax-free impact the price that FP was going to pay?
>
> A: Which price? The price - what do you mean by price we were willing to pay?
>
> Q: The dividend.

---

be greater if the return on its own contribution were included in its computation, but "has adopted for purposes of this motion the computations of the government's economist, Dr. Cragg." Reply at 3.

A: Well, again, that was the benefit in the transaction that allowed us to raise money at a very significant sub-LIBOR spread, because by BCI effectively receiving what were interest flows on a tax-free basis created value and that's what we were splitting between us, ourselves.

Q: Splitting what, I'm sorry?

A: That value that was being generated by the fact that they were getting tax-exempt income for what is normally taxable income, that was the value of the transaction.

Q: So you would talk about this tax value presumably?

A: Yes, definitely.

Q: Okay. How would those discussions go in terms of how you determine how to split it up?

A: Well, what we would say is, "Okay, you're going to get tax-exempt income. So if you keep all of the value, this is going to be the return for you in pre-tax equivalent terms." Pre-tax equivalent terms. "However, we want to get benefit in this transaction, we want to be borrowing at an attractive level so you're not going to get to keep all of that value, we're going to keep some of it." That is what the discussion was about.

> Q: All right. So how much of the benefit did you get?
>
> A: It varied from transaction to transaction.
>
> Q: Start with Laperouse.
>
> A: Laperouse, I actually don't remember the actual split, to be honest. I know that I think for us it was LIBOR minus certainly in excess of 100 basis points. I don't remember the actual number.
>
> Q: How about - sorry, I didn't mean to cut you off.
>
> A: I don't remember what Credit Agricole's equivalent return was. I don't know the split. In the case of Vespucci, I remember because it was one that I did myself, BCI's return was in excess of 'LIBOR plus 500' and for us the borrowing was in excess of 'LIBOR minus 300.'

Gabriele Dep. Tr. at 98-102, attached as Ex. 22 of Decl. of John D. Clopper.

His testimony corroborates Dr. Cragg's analysis that "AIG-FP's ability to 'borrow' at sub-market rates" was the result of "transaction terms which included AIG-FP paying the counterparties a tax-affected dividend rate." Cragg Decl. of Oct. 25, 2010 at ¶ 44. Dr. Cragg concludes that AIG-FP's cost of borrowing would have roughly equaled its return on the investment income if the SPV's

distribution had been taxable, "netting no gain" for AIG. *Id.* at ¶ 45.

For the purpose of this motion only, AIG does not contest Dr. Cragg's calculation. It asserts that as a matter of law, the tax-exempt status of the lender's dividend is not a tax effect to be isolated and removed from the transactions in order to determine the extent of their non-tax purpose and effect:

> The "solution," according to the Government, is to rewrite the terms of the transaction to "remov[e] the effect of taxes on the terms and structure of the transaction." The Government's expert, Dr. Cragg, is even more explicit. He says: "An economically correct profitability analysis absent taxes adjusts all the transaction terms and returns for the impact of baked-in tax benefits." The Government cites no case to support this entirely novel method of determining pre-tax profit, which would be based not on the actual terms of the transactions but instead on a fictionalized version where "all the transaction terms and returns" have been "adjusted" supposedly to remove the latent effects of taxes.
>
> This position incorrectly assumes that the point of the pre-tax profit analysis is to create a fictionalized "world without taxes." That is simply not correct.

2010 Reply at 26 (citations omitted) (alterations in original).

In other cases, removal of the tax impacts on a transaction might "fictionalize" it beyond useful analysis. But in this case, the SPV's distribution to the bank being tax-exempt was not a trivial or speculative factor: it shaped the transactions. AIG and its lenders considered the tax savings on the "dividend" to be "the benefit in the transaction" (Gabriele, p. 13 above), structured the transactions to get those savings, and negotiated how to divide them. According to Dr. Cragg (and disregarding AIG's own contribution to the SPV) AIG-FP and AIG would have enjoyed no profit from the transactions if the SPV distributions had been taxable.

Accordingly, AIG's motion for summary judgment in its favor cannot be granted on this record.

CONCLUSION

AIG's motion for partial summary judgment, Dkt. No. 109, is therefore denied.

So ordered.

Dated: New York, NY
March 29, 2013

/s/ Louis L. Stanton
Louis L. Stanton
U.S.D.J.

APPENDIX E — 26 U.S.C. § 78 - DIVIDENDS RECEIVED FROM CERTAIN FOREIGN CORPORATIONS BY DOMESTIC CORPORATIONS CHOOSING FOREIGN TAX CREDIT

26 U.S.C. § 78 - DIVIDENDS RECEIVED FROM CERTAIN FOREIGN CORPORATIONS BY DOMESTIC CORPORATIONS CHOOSING FOREIGN TAX CREDIT

If a domestic corporation chooses to have the benefits of subpart A of part III of subchapter N (relating to foreign tax credit) for any taxable year, an amount equal to the taxes deemed to be paid by such corporation under section 902 (a) (relating to credit for corporate stockholder in foreign corporation) or under section 960 (a)(1) (relating to taxes paid by foreign corporation) for such taxable year shall be treated for purposes of this title (other than section 245) as a dividend received by such domestic corporation from the foreign corporation.

APPENDIX F — 26 U.S.C. § 901 - TAXES OF FOREIGN COUNTRIES AND OF POSSESSIONS OF UNITED STATES - SELECTED SECTIONS

26 U.S.C. § 901 - TAXES OF FOREIGN COUNTRIES AND OF POSSESSIONS OF UNITED STATES - SELECTED SECTIONS

(a) Allowance of Credit. – If the taxpayer chooses to have the benefits of this subpart, the tax imposed by this chapter shall, subject to the limitation of section 904, be credited with the amounts provided in the applicable paragraph of subsection (b) plus, in the case of a corporation, the taxes deemed to have been paid under sections 902 and 960. . . .

APPENDIX G — 26 U.S.C. § 951 - AMOUNTS INCLUDED IN GROSS INCOME OF UNITED STATES SHAREHOLDERS - SELECTED SECTIONS

26 U.S.C. § 951 - AMOUNTS INCLUDED IN GROSS INCOME OF UNITED STATES SHAREHOLDERS - SELECTED SECTIONS

(a) Amounts Included. –

(1) In General. – If a foreign corporation is a controlled foreign corporation for an uninterrupted period of 30 days or more during any taxable year, every person who is a United States shareholder (as defined in subsection (b)) of such corporation and who owns (within the meaning of section 958 (a)) stock in such corporation on the last day, in such year, on which such corporation is a controlled foreign corporation shall include in his gross income, for his taxable year in which or with which such taxable year of the corporation ends—

(A) the sum of –

(i) his pro rata share (determined under paragraph (2)) of the corporation's subpart F income for such year . . . .

APPENDIX H — 26 C.F.R. § 1.901-2 - INCOME, WAR PROFITS, OR EXCESS PROFITS TAX PAID OR ACCRUED - SELECTED SECTIONS

26 C.F.R. § 1.901-2 - INCOME, WAR PROFITS, OR EXCESS PROFITS TAX PAID OR ACCRUED - SELECTED SECTIONS

Selected Portions of Section 1.901-2(a)

(2) Tax—(i) In general. A foreign levy is a tax if it requires a compulsory payment pursuant to the authority of a foreign country to levy taxes. A penalty, fine, interest, or similar obligation is not a tax, nor is a customs duty a tax. Whether a foreign levy requires a compulsory payment pursuant to a foreign country's authority to levy taxes is determined by principles of U.S. law and not by principles of law of the foreign country. Therefore, the assertion by a foreign country that a levy is pursuant to the foreign country's authority to levy taxes is not determinative that, under U.S. principles, it is pursuant thereto. Notwithstanding any assertion of a foreign country to the contrary, a foreign levy is not pursuant to a foreign country's authority to levy taxes, and thus is not a tax, to the extent a person subject to the levy receives (or will receive), directly or indirectly, a specific economic benefit (as defined in paragraph (a)(2)(ii)(B) of this section) from the foreign country in exchange for payment pursuant to the levy. Rather, to that extent, such levy requires a compulsory payment in exchange for such specific economic benefit. If, applying U.S. principles, a foreign levy requires a compulsory payment pursuant to the authority of a foreign country to levy taxes and also requires a compulsory payment in exchange for a specific

economic benefit, the levy is considered to have two distinct elements: A tax and a requirement of compulsory payment in exchange for such specific economic benefit. In such a situation, these two distinct elements of the foreign levy (and the amount paid pursuant to each such element) must be separated. No credit is allowable for a payment pursuant to a foreign levy by a dual capacity taxpayer (as defined in paragraph (a)(2)(ii)(A) of this section) unless the person claiming such credit establishes the amount that is paid pursuant to the distinct element of the foreign levy that is a tax. See paragraph (a)(2)(ii) of this section and § 1.901-2A.